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SFM - Q1 2020 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 1Q20 net sales of $1.6b and diluted EPS of $0.78.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sprouts Farmers Market First Quarter 2020 Earnings Conference Call. (Operator Instructions)

Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker, Ms. Susannah Livingston, Vice President of Investor Relations and Treasury. Please go ahead.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our first quarter 2020 earnings and long-term growth strategy call. Jack Sinclair, Chief Executive Officer; and Denise Paulonis, Chief Financial Officer, are with me today.

The earnings release announcing our first quarter 2020 results, our long-term growth strategy slides and the webcast of this call can be accessed through the Investor Relations section of our website at investors.sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding our 2020 expectations and outlook as well as our long-term growth strategy and financial targets. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our SEC filings, along with the commentary on forward-looking statements at the end of our earnings release issued today.

Our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to GAAP figures please see the tables in our earnings release. As well, to accommodate the additional time needed to discuss our long-term growth strategy, we have added an extra 15 minutes to the call today.

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With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today. We could not have expected the magnitude of change in our business that has occurred due to the COVID-19 pandemic, and I want to start the call by emphasizing how critical our team members particularly our store team members have been in this time of crisis. Grocery store workers around the world have become everyday heroes, working on the front lines to ensure people have the food and products they need to feed their families and, frankly, to survive. The more than 32,000 hard-working and profoundly dedicated team members of the Sprouts family have served countless hours under the most difficult of circumstances in order to ensure our customers have healthy food to feed their families. It's extraordinary how people are changing their view of our grocery store workers. Every day, they are rising to the occasion, showing up to their jobs, donning masks and gloves, carefully following ever-increasing safety measures and altered operational procedures and taking it in stride as they continue to prioritize customers and their needs.

Right now, we are focusing primarily on our people. The entire leadership team is inspired by the amazing work our team members and our partners are doing. It takes a community of dedicated individuals to keep our stores open in a time that none of us has ever experienced.

I want to thank not only our dedicated team members at Sprouts, but also all parts of our supply chain, our distribution centers, our drivers, our vendors and our farmers and growers who are all part of keeping the food supply chain running.

I'm inspired by not only our store team members, but by the decisiveness and agility of our leadership team and our management team who, when all this began, immediately jumped into contingency planning as we prioritize team member and customer safety while ensuring we remain in stock on fresh, healthy food for our communities. We are laser-focused on ensuring our team members are taken care of, and I want to share some of what we've been doing to support them during this global pandemic.

We accelerated and maximized bonuses and are paying monthly incentives in addition to bonuses for store and distribution center team members to ensure they are getting compensated at a time when they need it most. This is equivalent to more than $2 per hour. We want to ensure that nobody comes to work if they're feeling sick, so we enhanced paid sick time and leave. And we're guaranteeing every team member's job, should they feel the need to stop away for any reason during the crisis.

We've also created a disaster relief fund to help with things like medical bills and rent for those affected by the coronavirus. We've relaxed our attendance policy and shortened store hours to provide our team members more opportunity to rest. The health and safety of our team members is my #1 priority, and we've implemented a number of safety measures in stores to keep team members and customers safe. We've installed plexiglass at all the registers, and we limit the number of customers in the store at one time. We've also enhanced cleaning time lines for stores, including registers and production departments, and we're providing every team member with masks and gloves to wear throughout their shift.

I've said it before. Team members are the foundation of this organization. The success we have seen is due to them, to their tireless and diligent work keeping the wheels turning during these extraordinary times. And while all this is happening, we continue to drive our transformational strategy to ensure Sprout's long-term success.

I'll talk more about our strategy in a bit. But first, Denise will discuss Q1 financials. Before I hand this off to Denise, I want to welcome Gil Phipps, our new Chief Marketing Officer to the team. Gil's experience will be instrumental in shaping Sprout's long-term strategy to build brand awareness and loyalty with our target shopper. He brings a wealth of experience and development in building brands, and we look forward to his contributions to define and strengthen our private label.

Denise?

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

Thanks, Jack, and good afternoon, everyone. First, I hope all of you and your families are healthy and safe. I'll begin by discussing our business results for the first quarter and then hand it back to Jack to discuss the current environment and strategy. I'll join again to discuss the long-term financial targets for Sprouts.

First quarter profitability was very strong, with adjusted earnings before interest and taxes up 61%. The quarter was really a tale of 2 cities, so to speak. The first 2 months of the quarter were on track to deliver sales in line with the high end of our expectations and margins above our expectations due to the smarter promotional strategies we implemented late last fall. March followed with a dramatic increase in demand for food from the COVID-19 crisis, resulting in additional sales and leverage in the business.

First, let me review the highlights. In the first quarter, net sales grew 16% to $1.6 billion, and comparable store sales were up 10.6% compared to the same period last year. We estimate that COVID-19 positively impacted sales by $146 million and comps by 9.6%. For the first quarter, gross profit increased 23% to $594 million, and our gross margin was 36.1%, an increase of 180 basis points compared to the same period last year.

SG&A increased 16% to $436 million or 26.5% of sales, flat compared to the same period last year. SG&A included a pretax special charge of $1.2 million related to our ongoing strategic initiatives.

As for the story behind the numbers, the quarter started off with January and February on track to post comps at the high end of our outlook with slightly negative traffic. As well, our early efforts to refine and balance our price position, comp and improve margins through the elimination of inefficient promotions were positive to the business. In fact, gross margins were on track to exceed last year by at least 100 basis points. In addition, in the beginning of the quarter, SG&A continued to experience deleverage from higher health care and labor costs, the expansion of our home delivery program as well as higher occupancy costs due to larger stores.

Starting in March, consumer behavior dramatically changed as customers began to fill their pantries as COVID-19 stay-at-home orders led to less eating out. We experienced heightened comps in the middle of March led by grocery, frozen and vitamin categories, which settled by month end to a higher new normal, resulting in a 26% comp for the month of March. Sales were up in the store as well as through our digital home delivery and pickup.

For the quarter, e-commerce was 4% of sales, up more than 160% compared to last year. As March progressed, we continued to experience strong margins with stockpiling, attributing to a shrink improvement as inventories reduced, and a mix benefit. Recall, grocery, frozen and vitamins are higher-margin categories for us, and so these increased sales provided a better margin mix.

As the COVID-19 pandemic escalated, we leveraged the higher sales on fixed costs, like occupancy and marketing, due to our reduction in spend. As well, we were challenged to keep labor in line with heightened sales.

Offsetting this leverage, we made significant investments in pay and benefits to recognize our team members' instrumental commitment to serve our communities and to implement additional safety measures. We maxed out and paid early store and DC team members first quarter bonuses as well as additional bonuses. Sick pay also began to increase during March.

Moving down the rest of the income statement. Our depreciation and amortization costs increased 5% to $31 million or 1.9% of sales, a decrease of 20 basis points compared to the same period last year. Store closure costs and other credits were a $1 million credit compared to a $500,000 in costs in the same period last year, mainly related to a true-up of a 2019 store closure charge.

For the quarter, our adjusted earnings before interest and taxes were $129 million, an increase of 61% when compared to the same period last year. Our interest expense was $5 million, and our earnings before taxes were $123 million, an increase of 65%. Our effective tax rate was 25%.

First quarter diluted earnings per share were $0.78, and adjusted diluted EPS was $0.79 compared to diluted and adjusted diluted EPS of $0.46 in the same period last year. We estimate the positive EPS impact of COVID-19 was approximately $0.22.

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Excluding the positive COVID-19 impact, we estimate that adjusted EPS would have improved by 24% compared to the same period last year, which we attribute in large part to our ongoing strategic promotional improvements.

Throughout these uncertain times, we've been able to maintain healthy cash preservation. As most of you know, Sprouts' cash generation has always been strong, and this quarter was no exception. In the first quarter, we generated cash flow from operations of $277 million, up 146% for the year. We paid down $87 million on our revolver in the beginning of the quarter and allowed cash to build on the balance sheet for the remainder, ending the quarter with $247 million in cash and cash equivalents.

Reflective of our strong balance sheet, we ended the quarter with a net debt to adjusted EBITDA ratio of 0.6x, reducing our borrowing spread on our revolver by 25 basis points to 1.25%. Under the current pandemic environment, our near-term focus is to utilize the robust cash generation this business produces to invest in the business and maintain a strong cash balance for financial flexibility.

Lastly, we invested $17 million in capital expenditures net of landlord reimbursement, primarily for new stores. For the first quarter, we opened 4 new stores, ending the quarter with 344 stores in 23 states. We remain on track to open approximately 20 new stores this year. So far, only 1 store has been delayed due to the COVID-19 pandemic.

We've been closely monitoring our results, and certain trends we saw in the latter part of the quarter have continued into April. Elevated levels of grocery spend have continued as many consumers have increased their food and home spend. Social distancing has changed consumer behavior, including customers consolidating trips and increasing use of e-commerce services. As a result, for the month of April, comparable store sales increased 7.2% compared to the same period last year, notwithstanding the closure of all of our stores for Easter Sunday, the first time in company history.

Our average basket was $51, nearly double the historic average, and e-commerce sales represented 13% of our net sales in April. While the increased sales and our strategic initiatives around smarter promotions remain a benefit to margins, the timing of heightened investments to enhance team member pay, benefits and cost to implement additional safety and cleaning measures will weigh heavier in the second quarter compared to the first quarter. Because of this, we don't believe we will sustain the same level of operating margin expansion experienced in the first quarter.

The COVID-19 crisis has created a lack of visibility for the remainder of 2020 with many unknowns. We remain uncertain as to when the consumer behavior will return to normal or what may emerge as the new normal. This environment is making it difficult to predict specific outcomes and, accordingly, we are not reaffirming or stating a new outlook range. However, due to the strong sales and earnings to date, we currently expect that we will be able to meet or exceed our previously released annual outlook.

Our business is strong, our cash position is robust, enabling us to continue to build an even stronger Sprouts for tomorrow.

Now let me hand it back to Jack to discuss the current environment and strategy. Jack?

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

Thanks, Denise. Before I discuss our strategy, I wanted to share a few comments around today's environment. Given the unusual circumstances, I'm going to give color on the current trends. Denise's numbers show elevated sales levels that continued into April, though not at the same level as March. We believe the stockpiling is over. More importantly, our observation is the industry is experiencing a significant change in consumer behavior. In order to avoid social contact, customers are consolidating their shopping trips and shifting their visits more throughout the week and less on the weekend. The less trips are resulting in many more items in the baskets but at a reduction to traffic. No one knows how long these behaviors will last.

Social distancing has changed consumer behavior as well, leading to a significant surge in e-commerce sales. For April, our e-commerce sales increased over 950% from last year. This change in consumer preference prompted us to swiftly roll out our pickup service from 55 stores to all stores. We aggressively implemented the service to Los Angeles and Central California in mid-April and are on target to implement at all 344 stores in early May. This service, in partnership with Instacart, utilizes an innovative model with our team members performing the picking and delivery

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to cars. Many of these pickup roles will be filled with existing team members, which has presented even more opportunity for us to bring in new talent.

Throughout COVID-19, we have been aggressively hiring, creating thousands of new careers at Sprouts. Though it is much too early to define a new normal, COVID-19 has been a catalyst for trial of our e-commerce offerings, which could stick with many customers as we exit this pandemic.

Though we are keenly focused on the present, COVID-19 has provided us the opportunity to create trial and awareness of our brand as well as capture new customer e-mails and recruit more customers to our app to establish longer-term loyalty. Currently, we have paused many of our print ads as they are less relevant during these times. We've adapted our marketing spend to focus on customer acquisition and communication through more digital, social and streaming radio with the message to stay connected with us. This was highlighted by leadership videos, cooking-at-home ideas and #teamsprouts, which gained a tremendous positive response from customers, well above others in the industry. As well, we have discovered that in our newest 2019 vintage, we have seen an outsized lift in sales compared to the chain average. It's too early to tell, but perhaps the maturity curve for these stores is being accelerated as new customers are experiencing Sprouts for the first time.

Anecdotally, we've heard from many customers in our new markets that it was their first visit into our store as they were unaware of us before the crisis. The changing dynamics during this health crisis has prompted consumers to opt for healthier food, resulting in a mix increase to more organic sales and produce and more grass-fed beef and more antibiotic-free chicken.

As I mentioned earlier, our investment in our team members are our top priority. In fact, for the month of April, these expenses have increased from March with additional sick pay, added benefits and enhancements to safety and health measures implemented to protect our team members and customers. In addition to alleviate safety concerns, starting in March, we temporarily shut down salad, olive and soup bars and prepacked all our bulk into individual serving bags.

I believe there are always opportunities to be found in a crisis, and we are making sure to learn from this one. We're finding that customers are reacting well to prepacked salads, prepacked olives and grab-and-go meal solutions as well as the prepacked bulk options. All of these measures we have taken will help us become more efficient in the future.

One last topic to discuss before I move on to strategy, our supply chain, from our internal Fresh DCs to our partner, KeHE, have been adjusting to the daily changing demands to keep our stores stocked. Excluding a few weeks in March, our produce distribution centers have been and remain in good shape. The reduction in restaurant activity has created plenty of supply to flow through to our stores.

To keep up with the new heightened demand at our DCs, we have leveraged idle labor capacity from other industries. And to alleviate some pressure from KeHE, we've leveraged our 5 Fresh DCs to deliver fresh items like eggs and milk to the stores.

From a nonperishable standpoint, our buying teams took advantage of what we could to fulfill heightened demand. We are fortunate the products we carry in our grocery assortment are unique. And as a result, we have not been competing for limited supply against some of the larger players in the industry. Our service levels in April improved from our March lows, and we believe our stock levels have been better than many in the industry, in part due to this product differentiation.

Overall, I'm humbled by the team's response to the crisis, from the stores to the DCs to the support office. I'm very proud of the quick and decisive actions we took to ensure our stores remained open with food to serve our communities. It is a testament to the strong values of all team members at this company.

Now I'd like to transition into our strategy review. Despite the ongoing crisis, the team was able to finalize our strategic plan to drive the company forward. If anything, I'm more confident about our growth potential in a post COVID world. Our proposition of healthy, affordable food, supported by a compelling vitamin department and enhanced assortment in a smaller box, will be exciting for our target customer in the future. Please follow along with the slides posted to our investor website and linked in the press release today.

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Starting on Slide 4. Today, I will discuss our target customer, how we will elevate our brand, discuss our smaller format and market expansion and then outline our supply chain changes. Denise will wrap it up with our financial targets and box economics.

Moving to Slide 5 and 6. Being a relevant brand starts with insightful consumer understanding. We employ deep research to understand our target customer, what occasions drive purchases, what they buy and where they buy it. Our research yielded a better understanding of who really is our target customer. We found we over-indexed to 2 specific groups: health enthusiasts and innovation seekers, and this is where our future path will be focused.

Though these customers look for better-for-you options and innovative products to support their healthy lifestyle, we found we had significant headroom with these target groups to capture new customers by doubling down our efforts. As you can see from Slide 6, we can double our business by capturing just an additional 3% with our target customers. We should be the destination for healthier food.

In the past, we focused on many different customers, trying to be everything to everyone, which diluted our efforts to grow sales. One piece of data from our customer research that drove this home for me was we spent about 90% of our advertising money on aggressive promotions, yet it only spoke to the 6% of our customer base that is deal-orientated.

As well as on Slide 7. If the COVID-19 crisis has made me rethink anything in our strategy, it is how we can create seamless and contactless connections outside the store using e-commerce. I do believe COVID-19 accelerated e-commerce adoption in grocery that is likely to change the long-term trajectory in the United States, at least to a more elevated level than historical trends. Fortunately, our processes were in place for these services, and we reacted quickly to accelerate the rollout of pickup across the chain. Ultimately, we are agnostic as to where our customer transacts but instead focused on strong engagement and building brand equity with them.

Moving on to brand and marketing on Slide 8. The Sprouts brand is loved by our customers that shop with us, but our brand recognition is low. We know we can grow our share of wallet by more effective and relevant brand recognition marketing initiatives while spending less on promotions. There's nothing proprietary in promotion, and I would rather invest in items where we can drive differentiated benefit over long periods of time, like our Sprouts brand. Starting late last year and into this year, our marketing spend will lean into more brand building.

In our first test market, we pulled back on promotional print ads and increased our spend on cultivating our brand. Sales were slightly below average to begin, but sales quickly accelerated to that of our control group, all prior to COVID, to be clear. This work will progress, eventually flipping a much larger portion of our marketing spend to various paid campaigns in social, search, streaming medias and more, which can build top-of-mind awareness of Sprouts.

Our target shoppers are drawn to our product differentiation. Marketing inside and outside the store, we will highlight our product differentiation in each category. Like our attribute-driven Paleo, keto and plant-based campaigns, emphasizing digital shopping list and customer engagement around our buzzworthy smaller brands. Our ultimate goal is to make our marketing dollars more efficient and effective and, most importantly, help drive traffic.

To be clear, we're still promoting and providing good value every day to our customers, but we are doing so differently by being much more targeted. On Slide 9 are some great examples of these changes. In January of this year, we ran a promotion on locally grown strawberries for the Southeast region. In the past, this would have meant trying to be the lowest price in town on a broad promotion across all berries, and we would have sold a lot of them but with very little profit. Fast forward to 2020, we focused on a single item, strawberries, and the differentiation of the product, being local. The strawberry sales in this region comped north of 20%, with a margin that was up tremendously from last year. This displays not only our ability to highlight fresh product, but how our scale is allowing us to partner with more local growers. As well, many of these new promotions are being advertised to a more targeted customer through digital, with deals that motivate our customers to spend more.

Moving to Slide 10. Our store size will reduce to a 21,000 to 25,000 square foot store. And it will remain a health-orientated brand and deeply rooted in the farmers market heritage with a friendly store experience. No category will be eliminated, but we will integrate changes to reflect our target customer preferences. We're very excited to grow areas that our target customers prefer, like produce, frozen and further expansion of center-of-plate proteins, all focused on a differentiated product offering.

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Categories like deli will remain and will become more simplified. If anything, COVID-19 gave us a glimpse into what this may look like. It highlighted that simplified premade items like salads shelf and more complex, costly salad bars may not be necessary in future models. As well, it has allowed us to see clearly where we could gain SKU optimization. On the flip side, the new format will contain an innovation center where our vendors can demo new products, and incubator brands can display what is new and trending.

Looking back, we have higher expectations of the enhanced larger box than we have been building. And though it is an appealing box, these stores struggled to provide more favorable economic returns to cover the increased capital costs. And yet, we had a great model in our older vintages that were less costly to build and, therefore, a better fit for our ongoing rapid expansion.

On Slide 11, we highlight other smaller store benefits. We can reduce our nonselling space, and therefore, maintain a large number of SKUs. As well, the smaller store will have lower rents and will be more efficient to run with less complicated production departments. We believe these smaller stores can deliver sales on a par with the larger store as proven with historical locations we have today, resulting in strong returns of a simple model, setting us up well to expand across the country.

Moving on to Slide 12 to discuss our expansion plans. Based on an intersection of where our target customers live, the revenue potential and where our current and future DCs are and will be located, we narrowed our near-term expansion markets, which alone could provide 300 to 400 more stores. We will continue to focus where we are strong, like California and Texas, while building out Florida and the Mid-Atlantic to achieve a larger concentration of stores. Our plan is to grow at a minimum 10% annual unit growth rate but, most importantly, support our growth with our supply chain network.

Moving on to Slide 13. From day 1, I realized our supply chain was disjointed from our unit growth plans. That will change with this strategy. We have a commitment to our customers to provide fresh produce. However, with 5 DCs supporting 344 stores, with a number of those stores beyond 500 miles, freshness is hard to guarantee. Going forward, we aspire to have our DCs within 250 miles of the stores. Colorado and Florida are our first priorities, with the Mid-Atlantic on their heels. This will not only provide fresh product, it will optimize our supply chain costs. We plan to create a fast and fresh DC that aligns with our fresh partners in a more synergistic way. This may eventually lead to vertical integration in the long term, and we'll take advantage of cross-docking activities in the near term. As well, we will invest to drive efficiencies like demand forecasting to provide inventory visibility from the farmer to the store, while providing the ability to support scaling of the business without added resources.

While the current environment affects the precise timing of when these strategies will impact our results, I am confident all these initiatives will improve our store performance, drive efficiency, establish a tremendous unit growth trajectory and accelerate our future earnings.

Now let me hand it back to Denise to discuss our financial targets.

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

Thanks again, Jack. Over the last few months, we have challenged our internal performance expectations, our past practices, our box economics and our expansion plans. We set a high financial bar grounded in long-term targets, which we believe we can obtain. While the current environment affects our ability to predict the precise timing of when each of these strategies will impact our results, I am confident the strategies will lead to future earnings growth.

Starting on Slide 15. The basis of my discussion today is our goal of driving attractive profit growth and expanding ROIC by reducing our cost to build, driving annual 10% plus unit growth and delivering comps in the low single digits while stabilizing or expanding our EBIT margins.

Turning to Slide 16. As we evaluated our strategy, we realized our box was becoming too large and too expensive to build to maintain the economics we have historically. Jack hit on the benefits of a smaller store earlier. The result is a box that is about 20% smaller in square footage and with a similar reduction in fixture costs, leading to a blended cost to build of approximately $3.2 million, including inventory and preopening costs. It's important to note that this cost of our enhanced layout store had reached upwards to $4 million in 2019, so this is a substantial reduction in costs.

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Moving on to Slide 17. The target economics of the new box includes year 1 sales of approximately $14 million, with sales growing 20% to 25% in 4 years to annual sales of $16 million to $18 million. As Jack commented, these sales will be roughly flat to our historic trends, though in a much smaller square footage box. We expect that this will result in a blended 8% four-wall EBITDA margin in year 4. Considering our cash investment of $3.2 million, the box can yield approximately 40% cash-on-cash return by year 4, which should continue to grow into year 5.

We have a long runway of growth ahead. As we mentioned, we are focusing our near-term expansion in markets where we have a presence and where we can build out a dedicated fresh supply chain. Our goal is to have all of our stores within a 250-mile radius of our DCs. Some of our stores fall out of this radius, even with the future DCs, and we'll continue to evaluate them over time as part of our regular store performance reviews. For now, especially considering the heightened demand for food from grocery stores and the addition of new customers walking through our doors during these times, it would be premature to take any strategic action with respect to those stores.

In the near term, until the newer markets mature with more scale, they will pressure our earnings. Over time, market densification and the opening of new DCs will help improve this headwind to our financials.

We expect comparable store sales to grow low single digits. Key drivers of our comp performance, as shown on Slide 19, include enhanced marketing capabilities, a focus on innovative and differentiated products and e-commerce growth. Regarding marketing, to reemphasize some of Jack's earlier comments, utilizing more digital channels will elevate the awareness of Sprouts by focusing more on our brand while spending less marketing on promotions. We'll also attract our target customers through marketing that highlights quality, center-of-plate proteins and our differentiated products, many of which will be featured in center-of-store demo and tasting stations. Additionally, new stores will aid in comp growth.

One significant change to our new store strategy is our promotional schedule. In the past, our new store opening promotions were very deep and for weeks on end, therefore, reducing comps in the future. Going forward, we'll still bring value to our new customers but with a smarter, targeted promotional approach. While it will take a few years before the new vintage comp flywheel takes hold due to our scale today, we expect this new approach to benefit comps in the long term.

Moving on to Slide 20. Boiling down everything you heard today, our expectation is that we can stabilize to expand our EBIT margins going forward. From a tailwind perspective, as stated on our last earnings call, we structured our produce buying team, which improved our vendor relationships and allowed for better sourcing and product. We expect our in-store labor productivity initiatives, multiple year shrink improvement plan as well as our investments to improve the supply chain, especially leveraging new DCs in Colorado and Florida, will together improve our operational and infrastructure costs. Our shrink improvement in our Fresh departments will be the major driver in these savings, aided by the fresh item management system implemented last year.

Lastly, the new store box economics will contain lower rents due to the smaller size and a reduction in cost to build, lowering depreciation and amortization, both of which will be a benefit to the P&L. From a headwinds perspective, we expect labor and benefit costs to continue to increase each year. And while e-commerce will likely be an overall benefit to comp and profit, it will pressure margins, which we have factored into our targets. We continue to explore the optimal omnichannel setup for Sprouts, delivering on customer expectations while improving the economics of this channel.

For example, as Jack mentioned earlier, for pickup, we have started to utilize our in-house labor to support the Pick & Pack and fulfillment to customer vehicles. We believe Sprouts team members will be more efficient pickers based on their knowledge of our stores. Overall, netting the tailwinds and headwinds, we believe we can add a minimum stabilized EBIT margins, if not improve them in the future.

One aspect that has been a constant for Sprouts is our strong cash generation, as seen on Slide 21. Our focus remains on utilizing our cash flows to invest in our business to deliver strong returns. Unit growth is the first priority, complemented by other sales supporting initiatives, such as DC expansion plans.

On Slide 22, you'll note that our historic CapEx spend and our expectation for future years. Looking forward, our expectation is to keep CapEx spend in the range of 2.5% to 3.5% as a percent of sales, with the key variable being new stores. In the immediate term, through the COVID-19 pandemic, beyond investing in the business, we will continue to build cash on our balance sheet and maintain a strong level of financial discipline. Once this

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crisis has passed, we'll reevaluate our capital structure needs and determine the best alternatives for excess cash as the company continues to produce.

In summary, strong unit returns and ample market opportunity, coupled with low single-digit comparable sales growth, smarter promotions and other cost-savings activities, can lead to a stabilization and potential expansion of our EBIT margins. We believe our strategy will ultimately deliver attractive low double-digit earnings growth and expand our ROIC, thereby driving meaningful shareholder value creation.

We'll continue to serve our communities now and in the future with healthy, differentiated foods while delivering on these commitments to our shareholders. I want to thank our dedicated team members who make these compelling strategies and strong results possible.

At this time, we can open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question will come from Karen Short with Barclays.

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

Really appreciate the color on the longer-term outlook and focus. I mean I do want to ask some questions about that but, obviously, things are extremely abnormal now. So wondering if you could just answer a couple of shorter-term questions to begin with. Specifically on SG&A, is there any way to give us the actual dollar amount of investments in labor that you had in place for 1Q? I realize that's small. But then some color on how to think about that dollar amount in 2Q and then, once things normalize, what the stickiness would be on costs from a cleaning, PPE perspective, anything you could give on that would be really helpful.

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

It's difficult to be exact on that, Karen, in terms of how things are evolving and changing. It's difficult to know how much PPE we're going to need going forward. We're clearly going to need some. And it's difficult for us to evaluate exactly what that number is going to be. One of the reasons we're a bit reticent to be clear about where it's going to be going forward is some of these pressures going forward. I think the likely impact of a post COVID world is probably broken into 3 things for us and costs are certainly part of it, how much impact will it have on our wage rates, how much impact will it have long term on our cost in operating the stores, how much will social distancing impact us going forward. So I think it's difficult for us to put numbers to it. But it's clearly part of our planning going forward, and we're doing a lot of work on it at the moment.

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

And Karen, I think with the math that we gave you specifically as to what impacted Q1, you should be able to back into pretty well what the SG&A weight was in the quarter. But it was all really geared to supporting our team members and PP&E.

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

Yes. I mean, we were kind of coming up with the incremental SG&A for 2Q of about $60 million. So then I think the question is really that seems to exceed what the sales number will look like, if we kind of assume April was 7%, and then maybe May and June kind of decelerate from there slightly. So I guess it kind of backs into what -- obviously, you gave some numbers in terms of overall annual guidance being slightly better. But it really comes down to gross margin at that point. So maybe first thing, can you tell me if I'm way off on the SG&A on that $60 million for 2Q? And then I

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guess on the gross margin front, if you could give a little color in terms of how much shrink is benefiting you in terms of like 1Q, I guess, in the COVID period but also in 2Q? Because I assume you have some significant benefits from lack of like low spoilage. I mean that has to be hundreds of basis points. So any color you could give there would be great.

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

Yes, Karen, what I would say is I'd reiterate what we talked about in the script that we released. So April, we saw our sales up about 7%. And that included being closed on Easter Sunday, so that adds back 300 to 400 basis points to what we have seen in the April sales trends. And when we're seeing margin right now, we're still seeing benefits from shrink and we're seeing a little less mix goodness, as you would just assume, as people are back to buying produce and some other things in our store. In SG&A, I think your number is high. So just in terms of the total dollar amount of what we would foresee right now, your number is high. So I wouldn't be expecting that much to be coming through in what you're modeling.

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

Okay. And then just on the longer-term strategy. I know you said that you were not taking out any categories in the new smaller format, but maybe just a little more elaboration on what will be downsized. I know you did call out dairy (sic) [deli], but anything else you could call out would be helpful.

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

Sure. Karen, I think the reality of it is as we went to larger stores, we didn't actually put a lot more SKUs or categories into the store. We did some certain categories and gave it more space and did a better job probably in terms of the customer experience. Going forward, we're certainly going to double down on those categories that are very important to us and very important to that target customer grouping that we were talking about. And that comes down to produce, which is always going to be fundamentally important to us. And we won't be compromising anything on that, if anything, doing a little bit more in that space.

Frozen food has come out as a very important category because we're so differentiated in it. The fact that we've got so much plant-based, so much vegetarian, unique brands is really coming through strongly in this customer segment that we're targeting. So we'll probably give a little bit more space to frozen foods. And we'll probably look quite hard at our what we call center of plate, whether it be our meat business, whether it be our plant-based business, how do we become more of a destination for center of plate. Those would be the 3 categories that we're going to give a little bit more emphasis to. The consequential, we think we can do vitamins and supplements really, really well with a little bit less space. We think we can do bulk really quite well, although there's a lot of discussion going on about bulk, as you can imagine, in the current world. We think we can do that in a little bit less space. So we'll be flexing our space a little bit. Deli won't be quite as big, but certain categories will get a bit more space. If that gives some color to you, Karen.

Operator

Our next question will come from Scott Mushkin with R5 Capital.

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

So I just wanted to get into the April sales a little bit. And as far as it does -- goes with your long-term strategy about smaller boxes, it seems with our data that maybe you guys are just a little bit undercomping the industry so far in April. And I was wondering what you think may be driving that? And then forward, does it give you any pause about the strategy at all?

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

Yes. Scott, I'd tell you, when we look at our comp, we've got very significant that we don't have the benefit, if that's the right word, of the volume that has come from consumables in the space that majority of grocers have had a very big uptick on what you would call paper products and bleaches and all the obvious things that have come flowing through in that. We're not really in that space, although we've got some interesting offer in there. It's not something that's at the core of our business, and so we're not getting the benefit there. And the other piece of our business is we've taken out salad bars, and we've taken out soup and we've taken out dairy bars, olive bars. And we've restricted our bulk offer because of the amount of utensils that are involved in it. So if you take those categories out of it and you take consumables out of it, we think we're faring pretty well in the market.

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

Okay. That's really great color. So I have 1 more short-term and then a little bit of a longer-term strategy question. Everyone's obsessed with the SG&A and whatnot. But incremental margins have generally been about 15% on extra sales. As we think of you guys going forward, is it going to be way lower than that? Or is it going to be somewhere near that? Or how are you thinking about the incremental margin on extra sales? And then I had just one last one on produce pricing.

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

Well, the margin really, what's been happening in our margin over the last little while. As you know from the pre-COVID world, we were significantly enhancing our margins by being much more thoughtful about our promotion investments. So that -- and that continued in the first 2 months of Q1 and then into P3, we had the COVID dynamic, which changed it a little bit. The COVID dynamic enhanced the margin even more. And I think we quoted in our numbers what we thought pre-COVID. Post COVID, we obviously pulled back a lot of advertising because having the inventory to be able to support promotions became a real challenge. That naturally enhanced margins, and it will have done for the industry as well. The high top line that we had clearly enhanced shrink, which enhanced margins, and that flowed through pretty well. The mix -- our mix actually enhanced a little bit, and Denise said in her remarks, how the mix gets a little bit better because of vitamins and supplements, which has been a real strength for our business, particularly in March. And we've seen -- our grocery business has been strong as well, which for us, is an enhanced margin mix for us. So we're seeing some positives in that. And I think what's happened, when you're a more fresh-dominated business, when the restaurants kind of pulled back, there was a lot of availability of low-price inventory, which we were helping the farmers move through. And I think we've played a pretty good role in helping the restaurant and helping the inventory that was going to restaurants in fresh foods that we were probably better placed to take advantage of than some of our competitors or some of our -- the retailers that are operating in the grocery space. So those 5 things, some of them will be real for a long time. Some of them won't be real for a long time. So it's difficult for -- again, for us to predict the margin going forward. But I would be very comfortable that we'll be able to deliver on where we were pre-COVID on the margin growth going forward, if not beyond that.

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

I'll take the pricing question offline.

Operator

Our next question will come from Rupesh Parikh with Oppenheimer.

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

So I also have a shorter term and then a longer term. So I know you aren't providing guidance going forward. But if we see a comp similar to the April level, would there be enough leverage to drive positive operating margin expansion even with the higher level of cost?

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

Yes. I think as I mentioned in my remarks, I think that at the moment, we think that for the full year, we'll be able to meet or exceed what we previously guided. And then talking about Q2, I think that, as I said, we believe that we will not see the operating margin improvement that we saw in Q1. If we have elevated sales levels, it's still reasonable to believe that we will see operating margin at or better than last year in Q2.

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

Okay. Great. That's helpful. And I guess just going back to your addition of store pickup recently. Is there a way to help us understand, if you look at stores that have store pickup versus stores that haven't, what type of comp difference are you seeing between those 2 different classes of stores?

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

Well, the increase in the 55 stores that we had was fairly substantial. The reality of it is the rollout of programs literally just had -- there's some store -- I think we've got 40 more stores to finish, just I'm looking at...

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

Yes.

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

For a nod on that. We've got about 40 more stores to finish to get to 340. But these have literally just happened inside the stores. It's very clear from the 55 stores that we're seeing an uptick. It was very clear we were seeing an uptick on the delivery program, as we mentioned the numbers on e-commerce going forward. So I think we took the view that it was something that the customer would be wanting from us as part of the challenges on social distancing. And we think it's something that's going to be measurable going forward. Exactly what that number is going to be, I'm not sure. But I'm sure it's going to be more than what it was before we started.

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

Well, and in the very immediate term, we've seen generally a leveling out of the delivery portion of the business. We mentioned that it was 13% of the sales in April. With the rollout of the pickup portion of the business, that piece is still increasing in its contribution to the overall sales.

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

Okay, great. And my last question, just on the longer term. How are you thinking about price investments in your commentary that you believe you can expand -- have stable to expanding EBIT margins?

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

Yes. I think as I've said in previous calls, I fundamentally believe that our assortment and our products are such that it's very hard for us to have comparative pricing and invest in products because the key to us is differentiation. And as long as we've got value within that product that we're putting in front of the customer, the elasticity of demand will reflect what we need to do in terms of investing on our -- what we need to do with our margin. We're very clear that the important categories for us, we're investing in the right sourcing resource, both in terms of the big plays around how can we work on differentiation around varietal development in produce, breeding development in our meat business and our -- and

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really getting ahead of the plant-based trend that these products will be different for us, and we won't be under the kind of -- the focus on pricing will not be the way it would be if I was sitting in another grocery business, looking at other grocery business' comparative pricing. It's hard to compare us. We've got to have great value, and we'll judge great value by the elasticity of the products that we have. And that was working pretty well for us at the start of Q1. And then the whole kind of world's changed a little bit from March. But that's certainly the program that we'll be following going forward.

Operator

Our next question will come from Ken Goldman with JPMorgan.

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

I wanted to ask about a couple of areas of your store and whether you're able to either take advantage of some dislocations or whether you find those to be some challenges. And what I'm asking about in particular is produce, where we're obviously all seeing stories of some produce being unfortunately thrown out rather than sold. And then the meat side, where we're all, of course, hearing about some labor issues and plant closures, which are leading to some shortages. So just wondering how you're dealing with those, what some of the headwinds and tailwinds have been along those lines?

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

Yes. Good question, Ken, I know it's kind of very live in terms of how we're thinking about things going forward. And it kind of highlights the reality of the last few weeks for us all is that things change from 1 week to the next, from 1 day to the next. And the meat thing really did kick off dramatically in terms of excess demand in the middle of last week after the executive order was put in place, which highlighted the potential shortage of supply in meat. The great thing for our business is we tend to have our own supply base. So we've got a pretty tight supply base that works directly with us. We don't need the extent of prepacked meat. That is very much a feature of a lot of the grocers where they've deconstructed the meat business in the back of the store. So there's not as much butchery, not as many butchers and not as much, if you like, creation of product within the store.

So we're pretty well placed in that we've got a really strong team. We're really proud of the butchers and the way they've operated right the way through this crisis in terms of taking on board some real discipline in terms of how they operate in procedures and giving customers real confidence that there's the hygiene in place that needs to be in place. So we've weathered it pretty well, although demand has been pretty dramatic over the last few days. And if demand keeps going at the rate that it's going, you'll have shortages in meat. But it's supply, we're not so worried about. It's the level of demand that we've got to kind of manage ourselves. And we think we're well placed to manage that by having our own butchers.

With regard to the produce side of things, it's kind of pretty sad. I was listening to a congresswoman from Florida talking about Florida -- in Florida, with some produce potentially going to be thrown out. And our team really aggressively spoke to the Florida Produce Association and quickly moved that product into the stores. And obviously, at pretty low-cost prices, but we got this thing moved and got it into customers' hands. And we will be aggressively looking for ways to support local farmers as farmers' markets have kind of wound down across the country. We're really well placed to sell a lot of produce. And that's worked well for us being responsive and supportive of local -- the local source of produce supply. I think we're well placed to do that. And we structured ourselves to be able to do that better than we maybe would have been able to do 2 or 3 months ago.

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

Okay. And then a follow-up for me. I may have missed this, forgive me if I did. Did you guys address whether you've gone any further, made any concrete conclusions about what you're going to do with the deli business in your stores? I know there were some debates internally about directions to go there. I just didn't know if you had finalized anything on that side.

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

Well, specifically on deli, we clearly invested a lot of space and a lot of cost into the deli and what worked in our new format stores. That level of investment, that level of space, we will wind back. And so that will be a big part of the better utilization of space going forward. The deli business, and if anything, the COVID world has got us thinking very hard about how effectively we're going to provide, if you like, meals to go, ready meals, that kind of sector, something that we will be doubling down on how best to achieve that because in our -- in the post COVID world, it feels to me like the restaurant businesses are not going to rush back, not going to come back anytime soon, certainly aggressively anytime soon and that there's an opportunity for us to do the right thing in that environment. We might not have thought that so assertively pre-COVID. But post COVID, there is a way of doing this outside the store and creating really good products for customers that allows them to fulfill these needs. So early days, but more to come on that going forward.

Operator

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

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

I know you're not giving forward guidance as it relates to same-store sales. But as we think about the second half of this year, right, I'm curious to know if you believe that the right thought process is that the business will be trending back towards a 1% or so kind of comp level, which it sounds like what you were doing kind of pre-COVID? Or is your view that the initiatives and strategy that you've just outlined in terms of marketing and merchandising plans or perhaps what's still going on across the broader environment from a food-at-home standpoint, or as you mentioned, customers being introduced or reintroduced to your stores that you will, going forward, be at a little bit of a higher trajectory or run rate from a top line standpoint, even as this kind of pandemic starts to be behind us?

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

Paul, I think the simple answer to your question is, I wish we knew, right? I think that we're all watching what's changing in the environment very quickly. And I think that while, whether COVID is in place or not or stay-at-home orders are in place or not, we're seeing some goodness in new customers getting introduced into our stores or customers kind of reintroducing themselves to us. But in terms of where will we even be with stay at home and the volume of demand that will still be not in restaurants and still centering around home is really the part that we just don't know. So I think that we feel good that our strategy is going to keep pushing. If anything, COVID likely accelerated some of our ability to communicate with some of our customers just because they needed another outlet for food. But at the end of the day, it's really -- it's a bit of a wait and see right now.

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

Yes. And just to reinforce that, I think I don't know if we'll ever come back to a post COVID world that looks like a pre-COVID world. So it's difficult for us to envisage that. I do believe the trends on e-commerce and the trends on restaurants will be in a post COVID world. So what that will mean for our business, we just don't know. And that's the reality of it.

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

Understood. As it relates to the slide, I think it was 20, in your long-term plan, you spoke to stable to expanding EBIT margins and gave a kind of list of items that will contribute to that. I would say that it's very comprehensive and easy to understand what will transpire on the new store front. Just curious if you can get a little bit more detail on the actions taking place and the timetable in which you will impact all the stores as it relates to improved volume, the optimization of the supply chain, labor productivity, et cetera?

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

Yes. Let me start with a few comments, Paul, and then I'm sure Jack will jump in with some additional color. When you think about smarter promotions and improved buying, that's the work we've been doing. That is the work that Jack and the team started before I joined last fall. And I think that, that will only continue. And as we continue to think differently, in particular with our produce buying, with having both centralized and local resources to really take advantage of the best opportunities, I think that's an ongoing piece of work but one that has certainly already started and we've referenced a number of times as being part of the benefit that we are seeing now.

On supply chain optimization, we talked about Florida and Colorado DCs. We hope that we will have both of those in place by early next year. And as those come online, they'll very quickly start to help transportation costs, which is really a key part of the benefit that they're going to provide to get much closer to our stores for all the outbound products. So we'll get transportation benefit and freshness benefit at the same time.

A lot of the labor productivity changes are more likely to come along as we roll out initiatives that will be a little bit longer term in nature. So probably not next week or next quarter, but more out a couple of years in terms of the options we'll take there. One example of things that we're testing right now is we are testing self-checkout. We'll test and read that. But if that would be an initiative, we'd be able to push on that one. So those are probably a little bit longer term in play. We're working on shrink right now with the fresh item management program that we've got as well as a lot of other processes that we're working on in the stores, and we're starting to make some improvements there but, once again, a bit of a longer-term play, so not next week or next month, but hopefully in the foreseeable future. And then e-commerce and the labor and benefits costs are just real to us now. So that's kind of embedded in the numbers, assuming that they are here and here to stay. Does that help?

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

And just to reinforce that, the supply chain optimization will help us both in terms of shrink as well because the product, fresh product taking less time to get there, we'll be able to get a much better flow-through of the product, not throw so much away. And I think that's something that we can see potentially already some benefits coming through in the way we're thinking about it. But once we get shorter distribution channels, I think this will dramatically help our business towards the end of the year, beginning of next year.

Operator

(Operator Instructions) Our next question will come from Judah Frommer with Crédit Suisse.

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

First, I just have kind of a high-level question, kind of squaring some of the COVID-related comments with the longer-term plan. It does sound, as you kind of reset your sights on a new target customer, that maybe you're more focused on a specialty type store customer when historically the Sprouts story has been -- our key competition is the conventional grocer. So how do I think about kind of that potentially narrower customer building as big a basket going forward as maybe they are during COVID, given your limited SKU offering and kind of, like you said, the fact that you don't offer those national brands?

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

Yes. I think if you really look at the segmentation, first of all, I believe there's going to be more customers like the customers we are targeting because of a post COVID world. People are more interested in healthy eating. People are more interested in -- we're seeing it in our grass-fed beef sales, we're seeing it in our antibiotic-free chicken thing. Things that are perceived as healthier, more people are going to be interested in that in the post COVID world. And our vitamins and supplements business is performing very well which, again, I think with immunity and people thinking more about these things, I think there'll be more people within it.

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But in the slides that we went through, we need a very small number of people extra, and there's plenty of them out there. If you can see that slide, it shows a sliver of market share that we need to grow the business going forward. I wouldn't describe it as specialty. I would actually describe it as complementary. I don't see it as directly competing, maybe that's the difference, directly competing with the grocers for traffic. We're directly competing with people for their food spend, and I'm very confident that there's enough people there for us to more than achieve our ambitions. Whether we're defined as a speciality grocer, or a grocer, I'm not sure what we are, but I'm very clear that the target customers are there for healthier and very bespoke products that are created for the benefit of those -- that target customer base.

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

Okay. That's helpful. And just changing gears for a second. Given the ramp in e-commerce activity, to the extent you can, can you help us with kind of pre-COVID and maybe during COVID, the profitability on your online baskets? Are they -- obviously, they're dilutive to margin, but have you been making money on your home delivery baskets? And does that change with pickup? And then separately, how much customer data are you capturing, dependent on how you access the customer, right? If it comes through Instacart's app, what are you getting versus how many are coming through your owned website and app properties?

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

Yes. Overall, when we saw the uptick in e-commerce demand, I think the first thing that we'd reach out and say is we're so proud of our team members. We're so proud of our Instacart team members who are really stepping up and being able to try to chase this demand that was coming through to serve the customers that we needed to serve. Almost overnight, you start to see those orders increase. And to get capacity to service those is no small feat that is out there. The majority of our sales still come directly through the Instacart platform. So while we have some visibility to information on those shoppers, we don't have the visibility as much as it came directly through us, which is an opportunity that we'll always continue to look at for the future, so I think from that bigger strategic point of view, working on that piece. More broadly on the profitability, we definitely make money on our e-commerce business, both pickup and delivery. So it is a slightly lower-margin business because there are some additional costs that are paid through the system for that, but it is a profitable business. And we're really pleased that with our pickup business, we're really doing this hybrid structure that is letting us leverage our own team members that, if anything, because of their knowledge of the stores, should be that much more efficient at picking orders than what our Instacart partners would be, so really leveraging the best of both worlds of getting capacity and some additional expertise in the store.

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

Yes. And the baskets are much, much bigger with those customers. That's one of the things that is pretty encouraging in terms of that, in terms of we have the assortment and the product mix and the product range that really does attract -- that can attract big baskets, which is pretty encouraging as we look to the numbers going forward. And -- but we've got more work to do in terms of understanding our customer. And we will be doing a lot of work over the next few months and years about how we can better really understand the customers that we have. Not having a loyalty card means we don't have as much data as I would want us to have going forward.

Operator

Our next question will come from Chuck Grom with Gordon Haskett.

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

Can you speak to the cost to build out the 3 new DCs over the next few years? And then as a follow-up, can you remind us on how many of the smaller store concepts that you've tested in. You're expressing a lot of confidence that you can hold sales on a store that's going to be about 20% smaller. Just wondering if you can speak to any test concepts that you've done so far.

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

Well, we've got some test concepts written down on a bit of paper. We haven't opened any specific ones, but the great confidence we have is, I've got -- we've got stores that are that size all through our fleet that are doing higher sales than the bigger stores. So the economics are kind of already in our business. It's not like we're reinventing the wheel here. We will do some things that are going to make it more appropriate and better at maybe handling the pickup in e-commerce side of the business. We'll probably do a better job in terms of making our meat business come alive. But in essence, we've got the stores in our population. So it's not that I need to go and test anything dramatically. We just need to make sure we go back to where we were. It's going back to the future, if you like, going back to what we've done in the past. And those numbers are more than enough, what we've got in our existing fleet are more than enough to what we need to do. And that's encouraging going forward.

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

And on the DC side of things, the opportunity for us to expand and put the 2 DCs out there in Florida and Colorado comes with a very high ROI. What's unique about these DCs is they're primarily produce-oriented, so they're not incredibly high cost to build. Think millions of dollars, not tens of millions of dollars to put in place what we would need for these DCs. And the benefit that we get in transportation, because of how inefficient our supply chain has been, quickly returns the cost that it will take to build these out and get them stood up. So definitely think about this as a nice, simple, fresh DC. This is definitely not a high-tech complex DC to put on -- put boots on the ground.

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

And just from a timing point of view, Florida and Colorado will come before the mid -- we've not got -- we've not nailed exactly what we're going to do in the mid-Atlantic, yet, but we're very clear about Florida and Colorado. And hopefully, that will be up and running start of next year.

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

Okay. Great. And then just one near-term for me. Just wondering if you guys could just unpack the components of the gross profit margin performance in the quarter between better promotion efficiency in mix and then shrink. And then I guess, looking ahead, would you expect that level of performance to continue into the second quarter and likely to offset some of the increased costs that were asked about earlier?

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

Yes. So let me address Q1 first. So we talked about on the call, we were doing well pre-COVID with really being smarter promotions and kind of the way we were doing our buying, driving the vast majority of our gross margin improvement. And we mentioned on the call that, that was upwards of 100 basis points of improvement in gross margin. So think about that as the normalized improvement we were seeing from promotion and product buying as we were working through those early parts of the quarter. On top of that, then when you layer to where we ended the quarter, the big drivers that we had there were we did see lower shrink. We had higher sales, faster turning sales and, in turn, lower shrink as we saw elevated volume.

We were, and needed to, reduce some promotional intensity during those peak stock up weeks because, at the end of the day, we couldn't go out there with a promotion that we didn't know that we'd be in stock on to be able to service the customer throughout our stores and throughout our network. So in some cases, we very much simplified the promotional offering to what we knew we would be able to deliver to our customers. And then as we mentioned, there was a bit of mix favorability for us during that stock up in COVID because of grocery, vitamins and frozen, which for us are more profitable categories. And sprinkle into that a little bit of leverage that comes with an almost 11% comp, and that really got the incremental 80 basis points or so in terms of getting gross margin to 180 basis points up year-over-year.

When you turn to the second quarter, I think the color of a lot of the levers is still real. We're going to continue to work smarter promotions. We're going to continue to leverage the produce buying that we can do. And with the supply that is out there, leverage that locally where we can so that

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foundation remains. If we continue to see elevated sales, we would expect that shrink would still be a bit of a help as well. And then other things will start to balance themselves out, right? We have shifted our mix back to a bit more produce, a bit more meat, which are a little bit lower margin, so you probably won't see a mix gain, but you wouldn't have seen a mix loss. So net-net, I think that we believe that some of the trends will continue. But I would argue that in Q1, that COVID impact was just a very outsized impact, particularly in the last 3 weeks of the quarter.

Operator

Our next question will come from Greg Badishkanian with Wolfe Research.

Spencer Christian Hanus - *Wolfe Research, LLC - Research Analyst*

This is actually Spencer Hanus on for Greg. My first question is just for the stores you have in markets that have already started to reopen, think states like Georgia, can you talk about the sales trends that you're seeing there?

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

It's an interesting question, Spencer. We've been watching it really closely in terms of the dynamics. The 2 places that we've got a decent store base where things have changed a little bit in the last week or so are Texas and Georgia. If anything, and it's so early to say that I'm hesitating to be too bold about it, but in Georgia, we've not seen really any difference in customer behavior. There's still a lot of reluctance to kind of go into the stores have not changed. The traffic trends haven't changed. The basket trends haven't changed. Maybe in a little bit to Texas, we've seen a little bit of a difference but not much. And even different jurisdictions, it's interesting how different jurisdictions are doing different things at the moment. There's 1 county in Texas that said they're not going to go back until May -- what does it say, May 15?

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

End of May.

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

End of May. So it's -- I think it's too early to say, but my gut feel is that the customer isn't moving as fast with the changed orders.

Spencer Christian Hanus - *Wolfe Research, LLC - Research Analyst*

Got it. That's really helpful. And then switching to online, how sticky do you think the incremental customers that you're getting in that channel will be going forward?

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

I'm sorry, could you repeat that? You kind of broke up a bit.

Spencer Christian Hanus - *Wolfe Research, LLC - Research Analyst*

Yes. For the online customers, how sticky do you think they'll be going forward?

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

I think we don't know what we don't know. We know that folks early on, on the online ordering. As people were ramping up capacity, were ordering out of necessity that they didn't want to leave their homes. We're hoping that they've had a good experience and they want to think about sticking with us to do that. Not enough data behind us yet to really have a good sense of what that looks like for now.

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

But we're hopeful that as people experience the products that we've got and the brands that we've got, they're going to be sticky. That would be -- that would certainly be -- the implication of what's happening is the people that are accessing our brand in that way are in that bracket of customers that we're targeting. So they're likely to stay with it, provided we continue to do a good job for them.

Operator

And our final question would come from Mark Carden with UBS.

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

So how do you guys think about SKU substitution in this environment? Would you consider stocking more conventional items in this environment, if it's particularly challenging to keep up in stocks in any categories? And have you seen any major changes to your private label penetration since the virus broke out?

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

Yes. Again, good questions, Mark. In terms of would we go to a lot of the more conventional products, probably not. We haven't had to at that point. If we had nothing in the store, I suppose we'd have to think about that. But just at the moment because -- I think we talked about in our remarks, because our assortment is a little bit different, we're not battling against the big guys, the big club channels or the big mass channels in trying to access branded inventory that the other grocers are chasing after. We've got our own bespoke product assortment, which I think has stood us in good stead for a little while.

The private brand side of it has been a little bit more challenging as some of the private brand manufacturers coped okay to start with and then started to come under pressure, which has caused us to go and look for other alternative brands but very much in our type of space, the organic, very natural and organic space as opposed to mainstream conventional products. So we are having to do some substitution. We are under pressure in a few categories, as you can imagine. And private brands, we're having to be more flexible than probably we would like to be. So that's the nature of just supply chains at the moment across all sorts of different categories and products and industries.

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

Great. That's helpful. And then you mentioned e-commerce penetration reached 13% in April. Does the virus outbreak change your thoughts on where online grocery penetration could ultimately be for Sprouts? And would you expect to ultimately have to take on any major upticks in CapEx down the road for things like micro fulfillment or really any other capacity enhancing options?

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

Again, good questions. Yes, we do believe e-commerce is going to be bigger than it would have been. In my mind, it's bigger than it would have been. I think e-commerce generally has accelerated across the United States for grocery. I think they've probably gone forward 4 years in 4 weeks. And that -- whether I think it will stabilize, though, looking at some of the data coming out of China, what happened was there was a peak. They

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were operating at a level. They went off to a dramatic peak, and it's actually come back down again to a more measured level. What exactly happened in the industry or in our business, I'm not quite sure. But we will have to make sure that we're capable of effectively servicing a bigger e-commerce business going forward. And that will involve us looking at all the different strategic options around how you fulfill, how you deliver, how you pick, how you handle the last mile, and we're in the middle of doing some work on that at the moment. But having said that, I was really pleased, I would reinforce what Denise said. I was pleased at the way we were able to jump on the pickup thing and move from 55 stores to 344, literally in the space of a few weeks. And the team did a good job on that, and the customers are reacting -- at very early days seem to be reacting well to that.

Operator

Ladies and gentlemen, thank you for participating in today's question-and-answer session. I would now like to turn the call back over to management for any further remarks.

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

Thanks so much for just taking time to listen to us today. I know there's a lot going on and a lot of you in the East Coast. And I really appreciate you taking the time and showing some interest in our company. It's a very unusual time for us all in terms of the way we're working and the way things are going. So I really want to thank -- I want to thank you for doing that and taking the time to do that. I want to take the opportunity of thanking our own team for all their hard work and all the things that came together on that. And stay safe, guys. Look after yourselves and look after your families. Thanks ever so much.

Operator

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

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