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SFM.OQ - Q3 2020 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: OCTOBER 28, 2020 / 9:00PM GMT

OVERVIEW:

Co. reported 3Q20 net sales of $1.6b, gross profit of $585m and diluted EPS of $0.51. Expects 2020 adjusted diluted EPS on 53-week basis to be $2.26-2.30. Expects 4Q20 adjusted diluted EPS, inclusive of 53rd week, to be $0.36-0.40.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to Sprouts Farmers Market Third Quarter 2020 Earnings Conference Call.

(Operator Instructions)

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

It is now my pleasure to introduce Vice President, Investor Relations and Treasury, Susannah Livingston.

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

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

The earnings release announcing our third quarter 2020 results and the webcast of this call can be accessed through the Investor Relations section of our website at investors.sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding expectations for 2020 and beyond. 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 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 the GAAP figures, please see the tables in our earnings release.

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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.

We delivered strong results in the third quarter, with sales up 9.5% and comp sales up 4.2%. Our e-commerce business grew 337%, outpacing most e-commerce growth rates in the industry. We ended the quarter with e-commerce representing 11% of our sales. Our gross margin increased 400 basis points versus last year.

As a result, our adjusted earnings before interest and taxes were up $81 million, up 104% and our adjusted EPS of $0.52 was up 136% versus last year.

As we started 2020, we were focused on executing on our 5-year strategy of creating a highly profitable, differentiated specialty grocer with a long growth runway. Overall, the COVID environment has allowed us to fast forward certain aspects of our strategic plan, which has provided many financial benefits. We pivoted quickly to shift our print ads to digital ads, providing shorter lead times and the flexibility to source better buys and build smarter promotions that are not loss leaders. These changes, along with shrink benefits, have helped us achieve many structural and sustainable margin improvements.

As a result today, we are that differentiated specialty grocer, financially stronger than ever. While we still have plenty of work to do to realize our 5-year vision to double the size of our business. I am more convinced than ever of our potential.

Before I provide an update on a few pillars of our strategy, I want to emphasize that we continue to prioritize the health and well-being of our team members and our customers. We remain focused on serving our customers no matter how they choose to interact with us for the healthy groceries their families need. I'm pleased with how far we have come. And above all, I want to thank the team during this never-ending pandemic for providing service to our communities, taking care of our coworkers and delivering strong results for our shareholders.

Turning to our strategy. I want to share some progress in 3 key areas: innovation, marketing and e-commerce. And I want to highlight the importance of our produce merchandising and sourcing strategies.

Innovation is moving us forward. Our nonperishable departments like grocery and frozen are resonating with our customers, with comps higher than the company average. In 2020, we have launched more than 3,500 new and unique products, focused purely on innovation and taste. Some of these exciting new products include our seasonal in and out Hatch chile items like our grain-free paleo and vegan friendly chip, Sprouts private label vegan Matcha Latte Protein Powder and Remedy Organic cold brew coffee with MCT oil. Differentiated plant-based, keto, and private label in-and-out categories are all excelling, as these unique categories are targeted to our desired customer base.

As we speak, we are working through a deep dive of all of our categories to understand the needs and wants of our target customers and ensure that our innovation pipe engine is primed to bring even more new, innovative, branded and private label offerings to every department in our store.

Turning to marketing. In the middle of August, we launched new branding through TV, social, digital and radio under the campaign: Sprouts, Where Goodness Grows.

The campaign, which includes our first mainstream commercial onfarm fresh goodness, drives home our farmers' market experience by highlighting produce, the heart of our store and inspires health enthusiasts and experience seekers to engage with our brand. To date, the new branding has been well received. We continue to see our Net Promoter Scores among our frequent shoppers ranked best-in-class with our peers.

Brand building takes time, but our digital impressions have been impressive. We had more than 1.4 billion impressions of our master brand since its launch and over 2 billion overall media impressions, as we extend our reach with our target customer groups, the health enthusiast and the

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experience seeker. Our evolved advertising strategies are aimed at our target customers instead of attempting to blanket flyers to everyone in our market areas. We're now reaching more than 70 million confirmed views of our weekly digital flyer versus the 21 million print flyers distributed in the past. Additionally, we are leveraging the flexibility of digital communications to make our customers aware of what is new and different in our stores real time.

We use digital marketing to highlight unique seafood varieties that we don't regularly carry, which is tied to our seafood showcase. This was activated on short notice a few weeks ago and we saw seafood sales beat expectations. This supports the power of a differentiated assortment and targeted digital communications that we will leverage more in the future. From a pricing standpoint, we have a better balance of more everyday accessible prices and fewer ad items. In fact, in the produce department, we are seeing customers buying more items on everyday retails at lower prices than historic trends due to our investment in everyday price and fewer ad items.

In summary, we are in the early stages of brand development, but I'm pleased with the initial response. The opportunity lies with us to properly communicate and grow our target customers and their baskets over time. We're a $6 billion grocer in a $1.2 trillion market. We only need a small portion of market share to double in size.

As I mentioned earlier, we're excited that Sprouts is one of the fastest-growing e-commerce businesses in the second quarter and likely the third quarter. It is more important than ever to have a full omnichannel offering, as many customers use both in-store and online for their grocery needs. They complement each other.

In the third quarter, we launched delivery and curbside pickup through shop.sprouts.com so customers can order directly from Sprouts either through our website or the Sprouts app on their phone. While this service utilizes the Instacart order management technology, this improvement keeps the customer in its Sprouts ecosystem, allows us to leverage data for customer insights and does not require the customer to have an Instacart account to place an order, creating a seamless Sprouts experience for the customers.

When in shop.sprouts.com, customers can apply Sprout's exclusive digital coupons and speed up reordering with favorites and previous order history. Customers can even search and filter Sprout's product catalog by key attributes such as new, on sale and organic to find and discover products more easily. The additional data insights gathered allow us to customize our marketing spend and capture trade funds.

From a fulfillment standpoint, we utilize a hybrid model. Instacart performs the home delivery, and our team members perform the pickup in store. We believe our model is right for us, leveraging the scale of the Instacart marketplace while rapidly growing adoption of our owned e-commerce experience with the ability for the customer to purchase directly from our website while we capture meaningful data.

Finally, I want to highlight the importance of our produce business. As we look to the future, our produce will be fresher, more differentiated, innovative and buoyed by value-oriented special buys that are not loss leaders. Our product strategy is only enhancing who we already are, fresh produce at a great value. It is part of our DNA.

The addition of our 2 new DCs in Colorado and Florida in 2021, will allow us to be closer to our stores, which will create a fresher presentation to our customers. It will also allow us to take advantage of local and seasonal buying not available today. This year, we restructured our produce buying department. We created a centralized buying team, focused on specific large quantity produce categories and regional buying teams that foster deep relationships with the farming community and create partnerships for unique or new varietals in the future.

These meaningful farmer partnerships help us bring new and innovative products to our customers and ride the early wave of new varietals before they become commoditized. For example, today, we're working with a small grower focused on organic honey nut squash. Their quantities are too small for many of the large chains. However, due to our flexibility, we do not need their products in every store. Instead, it becomes a treasure hunt item found at Sprouts. This hybrid model provides us the ability to be nimble and react to pricing in the market and provides us with the agility to flex on size based on availability.

These relationships allow us to be a great partner to the farming community and is rewarded when we are the farmers first call when they are heavy on product. These spot buys provide us favorable pricing, which allow us to pass these savings on to the customer through great deals or

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everyday retails. This produce strategy allows us to build a path forward and grow with the farmers, which enables us to continue to surprise and delight our customers with fresh product, new varietals and special buys.

Now let me hand it off to Denise to speak to the financials.

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

Thanks, Jack, and good afternoon, everyone. In the third quarter, net sales grew 9.5% to $1.6 billion, fueled by sales from new stores and comparable store sales, which are up 4.2% compared to the same period last year. Our third quarter profitability finished strong with adjusted EBIT up 104%, driven by ongoing strategic changes as well as sales leverage.

Let me provide a little color on our comparable store sales. First, during the quarter, we were cycling an intensely promotional period from last year, with August and September having heavier promotions than July. Our data shows that purchases from highly price-sensitive shoppers who hunted for deals on our print ads slowed during the quarter as we continue to shift our marketing strategies to target customers with greater interest and assortment. This pivot was expected as we continue to execute our new strategy.

And second, regarding customer dynamics, trip consolidation appears to be a new norm during the pandemic. We don't believe we benefit from this trend, as we only carry a limited assortment of traditional CPG products like paper goods and cleaning supplies. As well, our geographic mix of stores is more weighted to regions of the country that saw slower overall food at home growth later in the quarter, as indicated by credit card data.

While pandemic-related dynamics and the cycling of week-to-week promotional unevenness from 2019 are likely to persist in the near term, we are confident that our strategic actions will result in a long runway of profitable sales growth.

Speaking of profit for the third quarter, gross profit increased by 23% to $585 million and our gross margin was 37.1%, a positive increase of 400 basis points compared to the same period last year. Numerous strategic changes we began late last year like everyday great prices with less ad mix, the elimination of loss leaders and shrink initiatives that continue to benefit gross margins. As well, lower sales of high shrink items like deli and salad bar positively impacted the margin.

We estimate approximately 250 basis points were enabled by COVID. We're excited to see the strategic structural changes to our margin taking hold. SG&A expense was $475 million or 30.1% of sales, deleveraging 200 basis points compared to the same period last year. Similar to recent quarters, we continue to reward our team members in the stores through special bonuses as we live through a year unlike any other in recent history.

In total, we estimate the additional SG&A costs associated with COVID-19 was approximately $34 million for the quarter, driving the deleverage. Additionally, with our high e-commerce sales, we incurred increased e-commerce fees, which were offset by other efficiencies and leveraging fixed costs on our higher sales.

Moving down the rest of the income statement. Our depreciation and amortization costs for the third quarter were $31 million or 2% of sales, a decrease of 10 basis points compared to the same period last year. For the quarter, our adjusted earnings before interest and taxes were $81 million, an increase of 104% when compared to the same period last year.

Our interest expense was $3 million, and our effective tax rate was 20%. Third quarter diluted earnings per share was $0.51, and adjusted diluted earnings per share was $0.52, compared to diluted and adjusted diluted EPS of $0.22 in the third quarter of 2019, an increase of 136%.

We continue to generate strong cash flow and maintain ample liquidity. Year-to-date, we have generated cash flow from operations of $410 million, up 27% from last year, and have invested $76 million in capital expenditures net of landlord reimbursement, primarily for new stores. Additionally, during the quarter, we paid down $176 million of outstanding debt, resulting in $275 million outstanding on our revolver and $138 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 0.3 times.

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For the third quarter, we opened 6 new stores, ending the quarter with 356 stores in 23 states. As of today, we've opened 20 stores with an intent to open 2 more stores this year. We're still in our journey to open new stores at a minimum 10% annual unit growth rate. Due to the pandemic, in 2021, we expect to open a similar number of stores that we did in 2020 and more back-end loaded. Our expectation is to open all 2021 vintage stores with a smaller footprint, adopting as many features as possible from our new format.

Turning to the fourth quarter. You'll remember that this quarter, we are lapping the first phase of our promotional efficiency efforts that drove merchandise margin improvements starting in the fourth quarter of 2019. Even with that, we expect to expand gross margins in the fourth quarter. As well, we'll end the $2 per hour look back bonus, but we'll continue to offer a bonus tied to performance for all store team members over the holiday season, a reward not offered by many grocers in the space.

We continue to expect additional expenses to keep our stores clean and safe for all. Bringing all that together in the fourth quarter, we expect comp store sales to be in the low single digits. And inclusive of the 53rd week, adjusted diluted EPS to be between $0.36 and $0.40, which translates to a full year 2020 adjusted diluted EPS range of $2.26 to $2.30 on a 53-week basis.

We remain confident in executing our long-term unit growth plans, winning with our target customers, maintaining our strong balance sheet and delivering sustainable superior returns. As we build out our 2021 plans, we are more focused than ever on maintaining the momentum we have captured in 2020, giving us confidence that our earnings before interest and taxes in 2021 will be in the range of $285 million to $305 million.

Now let me turn it back over to Jack for some closing comments.

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

Today, more customers are wanting natural and organic, looking for fresh food, more interested in the provenance of where their food came from and that their food was responsibly sourced and Sprouts has positioned itself to take full advantage of this trend. Across all aspects of our business, the team has done a phenomenal job in establishing who we are, which is really getting back to the original Sprouts model we introduced years ago to serve customers fresh, healthy quality foods at great everyday prices, supported by innovation.

In fact, over the last months, as we go back to our roots, we have demonstrated that we can even get back to Sprouts' original IPO profit margins. First, we're making tremendous progress on our strategy. What excites me the most is that we have so much more runway ahead, an improved supply chain, a new smaller format, continued product innovation and enhanced customer analytics to market to our core customers. We believe these initiatives will continue to improve our financial returns, driving industry-leading margins while creating more opportunities for our team members and allowing us to serve even more customers with healthy and innovative offerings.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

And our first question comes from the line of Paul Trussell with Deutsche Bank.

Krisztina Katai - *Deutsche Bank AG, Research Division - Research Associate*

This is actually Krisztina Katai on for Paul. I was just wondering if you could talk a little bit about your comp underperformance relative to the broader grocery market. You did mention that you were cycling some deep promotions. But what else do you think is the driver behind this? And

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also, as we look at the fourth quarter, you guided to a low single-digit increase compared to some of your larger peers guiding to about a high single-digit rate. And then just longer term, does this give you any sort of pause about your overall strategy?

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

Yes. I think the reality, we're playing our own game in the middle of this pandemic, and it's something that we outlined well before the COVID dynamics that have created a little bit of confusion. We are very set on the strategy that we've outlined, which is targeting specific customers, targeting a more narrow customer base than trying to appeal to all people at all times. And the reality of it for us is that, that's -- that takes us back to what we were originally, which is targeting on those customers who are particularly interested in the products that we sell and the proposition that we put in front of people. And we're very comfortable that, that strategy is working well for us.

The relative comps that come from inherent in your question is not something that we, quite frankly, are worrying a lot about. We do think there's some dynamics that Denise outlined in her remarks around the geography is a little bit different. The category mix that we have is a little bit different. And there's a few things that would make sense. When you don't sell a lot of it, the core consumables part of the grocery mix, you're likely to get slightly lower comps than the other -- than the comparatives that you're giving us. But we are feeling really comfortable about where this is taking us in terms of returns, where this is taking us in terms of growth. The fact that we've got fairly significant new store growth that are performing well, fairly comfortable with the data that we're seeing from the customer base that we are targeting. That as we continue to evolve the strategy in terms of innovation, continue to evolve the strategy in terms of digital communication to the target customers and appropriate promotions that work in terms of appealing to those customers. We're pretty comfortable that we can play our own game in the middle of this. And the guidance we're given, we're pretty comfortable with at the moment.

Denise?

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

Yes. I'd just add one point. I think it's important to bear in mind that our top line sales were 9.5% because we actually have a lot of new store growth, fueling our growth as well. And we, in doing that, I believe we acquired customers from other retailers. And we've got a tremendous amount of white space going ahead for us in the country, as we've outlined in our strategy. And I think that's an equally important part for us to balance as we're also managing the costs.

Krisztina Katai - *Deutsche Bank AG, Research Division - Research Associate*

No, that is great. And I just wanted to ask one follow-up. So you did lay out an EBIT target for next year in the range of $285 million, $305 million. Can you just walk us through some of the key drivers that you need to achieve in order to hit these numbers? And I guess what is just your general level of confidence around putting out a target like that.

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

I think as you'd know, we would start early working on our 2021 plan. It's an interesting year to have to lap from 2020 into what will happen next year, how long COVID trends will persist, kind of what that process will look like as we hope that the country will be reopening. I think for us, we're very excited about having had the opportunity to reset our financials in 2020 and believe that the majority of the changes to our financials focus on our margins are structural and sustainable. And that's a lot of what is driving our confidence in what we'll be able to deliver last year -- next year based upon what we're delivering in 2020.

And I think we also see the runway of other improvements that we're going to be able to continue to make that will make it a great shopping experience for our customer, but also continue to fuel the profitability that we're able to drive. Withstanding up our new DCs, the new smaller

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footprint stores, we're going to start to roll out, continued focus on data analytics and customer analytics. All things that are going to have our strategy continue to come to life, while we're leveraging the momentum that we gained from 2020 and our margin structure.

Operator

Our next question comes from the line of Mark Carden with UBS.

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

So first, is the COVID pandemic and shifting consumer behavior caused you guys to make any changes to your new store prototype? And by that, are you planning to expand or pull back on any of your departments within stores relative to what you may have planned earlier this year.

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

Yes. It's a good question, Mark. And clearly, the pandemic has had some dynamics that have caused us to kind of second-guess some things, reinforce other things. But particularly with regard to e-commerce, I think that was the piece that maybe when I was talking about this at the back end of last year when I first joined, we probably weren't as focused on the growth in e-commerce that may -- that certainly has happened, and we continue to think that will be a stronger element of our business going forward as people engage with our brand.

So the format will take a little bit more accommodation for how to effectively service those needs. So the space for pickup, how we handle pickup within the format, that will evolve a little bit and has evolved a little bit in our thinking, as you would expect. And I think we -- we're even more focused on how important what we call center of plate is, as people have become more kind of, I suppose familiar with eating more at home. We think that element was maybe going to be stronger than we envisaged, again, pre-pandemic, which seems so long ago. But the pre-pandemic view we probably -- we've evolved a bit in terms of how we're going to position and source and put in front of the customers, what we'd call our center plate meat, plant-based center product. And I suspect the baking and cooking ingredients part of this whole proposition is going to be stronger as well going forward.

So we've evolved a few things. Things have stayed the same. We believe frozen food was going to be strong, and it's probably even stronger now. And we were committed to giving a lot more space to that to allow us to peel to the customer base around vegan and paleo and vegetarian, which we're very strong at. So that's probably been reinforced as opposed to changed by the pandemic. But that gives you a flavor of the kind of things we're thinking about, Mark.

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

Great. And then a follow-up on the quarter. Just how are you guys thinking about your market share performance on a comparable mix basis? You guys think you're performing in line with the market and the categories you compete in.

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

Yes. I think what I've kind of outlined a little bit in the remarks is we think we're holding our own on grocery and frozen, if not even doing a little bit better on that. We think the consolidation of the trip as Denise said, probably hasn't helped us with regard to the full shop relative to other people within that. But as we look at certain categories have been things like bulk, which I'm very pleased the way the team are dealing with it have been kind of compromised by the kind of restrictions have been put in our place. I think that will bounce back, and that's been a significant part of our business. It's not a significant part of many of the other people that you're comparing us with.

So I think we think we're holding our own. Having said that, we've also outlined the promotion changes year-on-year, which were very specific about how we change the momentum of who we're speaking to. And that's got some implications short-term that we work our way through.

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Operator

Our next question comes from the line of Scott Mushkin with R5 Capital.

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

I appreciate the questions. So I was just wondering, Jack, I mean, I heard the thoughts around the sales slowdown. And I guess I'm just trying to get my arms around it vis-à-vis what I concur with you is really great Net Promoter Scores from what we see in our research. And then also the store execution, which seems like the team has done such a great job. So it kind of leads you to think maybe there's -- maybe some torque or tweaks that can be done on the go-to-market strategy. And I was wondering what you think regarding that, do you need to kind of tweak things just a little bit, so the traffic and sales get more in line with the industry.

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

Yes. Again, it's a good question, Scott. As we think this one through. We're learning and practicing and changing our thoughts as to how we do this. And the first thing that I've been trying to do is reestablish the base business model in the business, which is getting us to a point where we are operating without compromising our margin to drive the sales. And I think that's something that I'm feeling pretty confident about as we experiment with new tactics. And we're experimenting with new digital tactics as to how to effectively make that work. I outlined a little bit in my remarks about the number of impressions that we're getting.

We're continuing to learn how to take those impressions and turn them into traffic and turn them into sales. I kind of outlined the seafood thing, but that's a little thing that we're doing, and there's a lot of other things that we've got in the hopper to think through. So it's by no means in the place where we've got this mix of how we promote, where we want it to be. And the key thing for us going forward is we're really clear about the customers that we're targeting, and we're really clear about how we want to approach those customers. And we're really clear that, that does not involve huge loss leading grocery promotions that you would see across the industry.

It's not what we are going to be good at. It's not what we're going to win with going forward. And I'm feeling very confident that the segmentation and the communication is the right direction for us to go in. And we, as a team, as we learn how to do this, we'll get ourselves much, much better at it over the course of the next few months.

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

I appreciate that. So my follow-up question is regarding the new format and the changes going on with the consumer. And how you think you're going to maybe enhance kind of ready to eat, ready to heat, ready to cook? Does it look like consumers going to want those solutions in a much bigger way going forward? I just wondered if you could maybe talk through how you guys are thinking about the merchandising as the new prototype comes out.

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

As we want -- and this will affect more than just a new prototype. As I talk through the different categories in terms of how things have evolved and developed. Baking, cooking, spices, that assortment is something that we are evolving and developing. And the nature of our business being very good at gluten-free and very good at the specificity of the ingredients and the attributes of those products.

We've been doing a lot of work on that, and I'm pretty confident that we'll have that differentiated offer in those spaces, which I do think is going to have some sustainability going forward. Frozen Foods is something that as I said before, we're very strong at. We'll continue to evolve that. And the grocery team have been going through category by category. Taking on board the trends of this year and looking at the healthy enthusiast and the innovation set, the experience, seek customers that we're targeting and identifying those products that are going to make that work.

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When it comes over to the other side in terms of what you're talking about regarding meals and ready to meal and how to go, we've got a pretty strong business on pan meals, which is evolving and developing within our meat proposition. And I'm very pleased with the program with what we are going to be doing in the product in the new format.

With regard to our meat business and with regard to our plant-based business, we're very strong in plant-based. And that's coming together pretty well in terms of what we're going to have in terms of how we're going to put that in front of the customer. And then with regard to meat and meals. And we're going to be very -- we're going to focus in on those attributes that matter a lot and differentiate us.

Grass fed, no antibiotics in the product, the sourcing and the providence of where the product comes from. The animal husbandry that's involved in it. We're going to be talking a lot about that in our stores. Talking a lot on that to our customers. And it's very clear to me that this combination of the healthy eating customers are interested in this provenance of the food and what's in their food very much so. And the innovation seekers are looking for taste and credibility from the retailer itself from that. And we're going to be very different in those spaces in the format going forward. And we'll continue to develop our meals business as to how to do that even better than we're doing it at the moment.

Operator

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

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

This is actually John Parke on for Chuck. I guess within like the 4Q guide, can you talk a little bit about your expectations for gross margin improvement as you lap some of those promotional changes from a year ago and then kind of the headwinds related to COVID and some of those e-commerce costs continuing?

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

Sure. So as we laid out in our guide, we continue to believe that our gross margin will expand versus a year ago. Even though in the year ago period in Q4, we had started the promotional journey that we are on in terms of resetting that base and getting away from inefficient promotions. We do believe that COVID has still enabled us to do more in that space on the margin front, but also importantly, on the shrink front as well. We've kind of done a step change this year in what we've been able to do to manage shrink.

So those 2 items combined have us feeling great about continuing to deliver some additional gross margin improvement this year. And on the SG&A front, as I mentioned in my comments, while we're stepping back from the $2 look back bonus, we do still expect to see some other COVID costs come through. So we continue to supply PP&E to our stores. We continue to maintain extra levels of cleaning discipline. And we are still offering a bonus to our team members in the quarter, unlike what some folks might normally do, we have a performance-based bonus that our stores are eligible for each quarter. And we've really communicated to them and double down on that piece as well as we're thinking about the quarter.

But net-net, expect to have a good quality quarter come through on both fronts as we're managing those SG&A costs and pulling a bit of that lapping compared to other quarters down and then continuing some gross margin strength.

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

Got it. That's helpful. And then just kind of switching gears a little bit. Is there any update on rolling out potential loyalty program kind of here in the near term?

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

Yes. So I can speak to that a little bit. I think what we want to make sure that folks understand is we actually have the technology in place today to have a loyalty program, and we do collect e-mail addresses and have that information. What we've never really done before is overly activate the use of that loyalty program in terms of a rewards-based program or some other kind of value to the customer. We've primarily used to as a means to be able to communicate to our customer about the weekly ad, upcoming coupons, new products, innovation.

We're exploring and thinking about ways that we might be able to expand that to make it a little bit broader that might increase the appeal of people belonging to the program and using that loyalty card. But overall, we have the capability. We're using it in a much more simplistic way today and are evaluating if there's a plan in the future to expand that a bit more.

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

And we're successfully expanding the number of e-mails that we have. And then using that -- those e-mails to really target the customers that we've been talking about the narrow target that we have. So in the short term, we're going to use e-mails much more effective than we have in the past.

Operator

Our next question comes from the line of Ken Goldman with JP Morgan.

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

I wanted to make sure I understood the comment correctly about getting back to original IPO margins. Sprout's EBITDA margin peaked at 8.7% in 2014. Is that what you're talking about is the kind of level you can get back to sustainably? It seems like a little bit to me of a high bar, just given how much the world has changed, e-com being margin dilutive and so forth. So I'm just curious what the major drivers are to kind of get you back to that level?

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

Let me talk a little bit about how the world might have changed or not changed since that period of time, and then I'll let Denise talk a little bit more about the specific numbers, where we've made a huge progress over the course of this year. And I think we've probably moved faster than we anticipated when I talked about this well before the COVID environment. The pie is so much bigger on natural and organic than it was when and this IPO was originally done. It doesn't take much for us to get huge growth in this market without taking huge market share because the pie is much bigger. And because we are solely focused on it. I think the point about when the IPO happened, Ken was perhaps people were saying well everyone's jumped on this bandwagon now. But first of all, nobody is jumping on the bandwagon to the point that they don't want to do anything else, which means they're limited in how they can do that, and the pie is much, much bigger.

So I'm feeling very -- it doesn't take much, as I said, of market share for us to be very confident that we can get good growth even this quarter, the 9.3% growth with the new stores is pretty significant in the space in which we operate in. So from the point of view of the size of the price, it's pretty big. And the point of view of the margin opportunity, I think we've demonstrated this year exactly what that margin opportunity is in this space. And there's a little bit about it in COVID, but not much of it is to do with COVID. So I'll let you -- I'll pass on to Denise just to talk a little bit about going back to those numbers that you described as a high bar.

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

Thanks, Jack. I think when you comment on the numbers, when we go back and look at the financials around the time of the IPO. We're really looking that there was an EBIT margin out there around 5%, 5.5% range. This year has been a really good year in terms of us proving that we can get back into that range. Now as Jack said, I think what we did this year is prove that we can get into that range. We feel good about where we're there. We know that we have levers to pull. Whether that's the exact number that we're going to stick with over the long term, and it's not necessarily setting a new target. I think the element of communicating it was really saying. Those numbers are not out of reach for what we can do, given the results that we're actually posting this year.

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

Okay. And then my follow-up is, you talked about targeting specific customers, getting back to a narrow base. I understand the strategy. But I'm curious, when do you think this sort of culling dynamic starts to lap or to fade? Because it's a little difficult on our end to necessarily model strong comps until we get just a little bit better visibility into that dynamic. And I guess I'm also curious, what gives you confidence that you're not cutting into the bone-in of core customers right now, the ones you really want to keep. Yes, yes, you have some loyalty, but it's email addresses. It's not a loyalty card. I don't know how you necessarily know which customers are the core and which are not.

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

So I mean, I think the thing that gives us a lot of confidence that the customers we're targeting is the size of our basket. So we're getting through this and the NPS scores. The people that we are targeting truly love Sprouts. And we just need to communicate to more of those type of people, what the opportunity is if we come into Sprouts and go forward on that. There's plenty of them. We know that. We know the size of the market. So the market opportunity out of that were at $200 and something billion as a market opportunity out of the $1.2 trillion, $1.3 trillion whatever the number is trillion dollar market. So that narrowness gives us confidence that there's enough people there and that we communicate with them effectively. With regard to cutting into the bone, I think -- I think I said at one of my very earliest calls was what we don't want is the promiscuity of shopping that we've had by having very aggressive grocery, produce and grocery price points that are loss leaders.

Those customers are not the long-term customers that are going to make it work for us, and that's what we've been planning for well before COVID. The confusion, I suppose, for all of us as we try and win this for next year and the year after, has been how much of these dynamics have been affected by the COVID environment and how much of it is down to our very specific work that we're doing. There is no doubt that there's been a consolidation of trips, which has probably lost as some of those customers that we -- that you're identifying in the nontarget space. But we're feeling pretty confident that the people that we're targeting have got plenty of room with there's plenty of room for us to grow when we get past this COVID environment so that we can truly understand it better.

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

And I think there's 2 data points tied to our stores that are also important indicators of how the target customer is working for us as well. When we look at our stores in aggregate and we put them into files and then we stack up how many of our target customers are in that proximity or in that area around those stores versus how many in the nontarget customers. You see a direct correlation to kind of the detail of store performance and the customer count that we have that's in those target customers in the MSA as a whole. The other thing on a more narrow basis is we've actually gone back and looked at for new stores that we've opened in the last 12 to 18 months. And said, if what we had used at the time was data around our core customers, our 2 target customer segments around those stores versus the segmentation that had been being used previously to guide new store choice.

We're disproportionately performing better in our new stores, where that target customer count on the new target customer basis is higher than where we are otherwise. They're all doing fine, but you can see a bit of a step change difference where we're closer to those 2 target customer segments today when you go look at what we opened through the 2019 period.

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Operator

And ladies and gentlemen, due to time constraints, we ask that you please limit yourself to one question.

Our next question comes from the line of Greg Badishkanian with Wolfe Research.

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

This is Spencer Hanus on for Greg. I think in your prepared remarks, you mentioned that e-commerce was 11% of sales at the end of 3Q. Are you expecting online mix to remain at that level as we head into 4Q and then into 2021? And then how do you think -- with e-commerce at that level and now moving potentially more of that business on to your own website, how do you think that change will impact your ability to manage the margin headwind there?

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

I think given that we had 11% in Q3, the margin performance was pretty kind of demonstrated in terms of the numbers that Denise went through a little while ago. The way we've managed that, it's been pretty effective for us in terms of it's a profitable mix and the basket is very strong within that. In terms -- I think it will moderate a little bit but who knows exactly. I don't think it will go back to where we were, that's for sure. And I think I would see it moderating a bit from where we're at. But I think it'll end up very significantly higher than where it was as a mix of our business. And I think that, again, when we look at the customer data, the encouraging thing for me is this omnichannel customer that's so important to the I think the grocery space going forward. And as I said earlier, it's become more important in my mind for our company than it was a year ago.

That omnichannel customer, I think we're serving them well. And if we can get the communication of the brand to those customers and then let the customer choose how to interact with the brand. I think we'll be in a strong place to do a good job as an omnichannel retailer, combining the strength of the in-store experience and the brand messaging in terms of letting people access what they want going forward. The other dynamic as we evolve through this that I'm pleased about is I think we're going to be able to get more customer data in terms of the way we're evolving our e-commerce business. And that data will serve us well in terms of how to understand, how to service those customers even better in the future.

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

And I think we think there's a great partnership between what we can do on our own website, keep people in our own ecosystem who just want to experience Sprouts. But we also don't lose the benefit of a good partnership with Instacart and good traffic to an Instacart site where people are just looking for that convenience every day. So now what we're really able to offer folks is a choice between them that they can make that we don't need to make for them.

Operator

Our next question comes from the line of John Heinbockel with Guggenheim.

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

Jack, maybe you can talk to -- you mentioned before in and out items and product introductions. Where do you see that going forward in terms of the intensity of introductions? How much do you want to be a treasure hunt retail or have that as part of the mix? And then how do you manage the planograms around that, if you are going to have more treasure hunt items in the store?

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

Yes. Again, it's a good question, John. And as we think through this, I've been really pleased, for example, right now in terms of the harvest items that we brought in private label to really have them in and out. We've got some great seasonal items coming through in private label, which very much relate to the target customer that we've got. And I would see somewhere, and the number is going to somewhere between 20% and 25%, especially in our grocery business.

I'd like to see that kind of level of innovation coming in and out to constantly create interest for the customer, that -- particularly that experience, seeker customer, I think we can be the destination for the kind of healthy and diet focused innovation customer across the marketplace. And we're going to have in our new format stores, very specific space for an innovation center, where we'll really make this come alive. And the teams are working very hard about how to get further upstream on innovation. So that we're closer to the new things that are happening, both branded and what can we do private label.

So I can see it being 20%, 25% of our mix, particularly in the grocery business. In terms of managing the planograms behind that. You're right. One of the things I'm trying to avoid is becoming is a super efficient planogram-driven retail business. Because I think if you do the kind of things that I'm familiar with at Tesco back in the U.K. or Walmart here in the U.S., where you get very disciplined about space and faces and items.

I think you missed something along the way. So the work that we're doing on our system evolution, and there's a lot going on behind the scenes on that in terms of how to make that work. It's creating a flexibility so that we can be a farmer's market so that we can bring things in and take them out while having discipline in our inventory management behind the scenes. And that's one of the, as Denise talked about the runway is ahead of us. It's one of the runways ahead of us that's going to get its real differentiation. And get a balance of how to make that efficient without becoming, if you like, too boring and sometimes planograms make you too boring.

Operator

Our next question comes from the line of Brandon Fletcher with Bernstein.

Brandon Fletcher - *Sanford C. Bernstein & Co., LLC., Research Division - Senior Analyst*

One real quick question. I'd like to pivot to the new customer segmentation. I think it's very disciplined. We think the assortment changes make a lot of sense. We always look for kind of a second attribute to attract that customer. And so if you could help us give a little clarity on either it's kind of a service offering that helps pull that targeted customer? Or it's just a convenience play as you get more and more stores rolled out? Help us understand kind of the other attribute that pulls that segment you're after in addition to really quality assortment.

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

Yes. And I think one of the things that appealed to me about Sprouts in the very first place was the sheer quality of 2 things: the format itself, the low profile, the centering of produce at the back of the store gives it a very natural feel that targets well irrespective of the products that are in it, it targets very well. And the other piece is pretty amazing is the quality of our people in terms of the service element to the customer. I think our NPS scores would suggest that we're better than most of that, if not even stronger, I could maybe even be stronger about how positive our target customers feel about the interface that they get in our stores, whether it be the guy behind the seafood counter, whether it be the executive people we've got in our vitamin category who are giving advice to people in terms of what they should be doing and how they should be thinking about things.

So those 2 elements to me are pretty fundamental and differentiated, not to do with product in terms of the format itself. How it comes alive with a low profile and people get confidence by looking around the store. And as I said, I'm going to build some better communication as to what that means inside our store. And then the people themselves, which is testament to what the team that built this thing originally. It was based on this kind of a starting point of being -- communicating with customers and giving them a lot of confidence that there's expertise. I think you'll be hard

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pushed to find people that know more about the product that they're selling than the Sprouts folks. And I think that's a huge plus in terms of the customer target that we're going forward.

Operator

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

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

I don't think you said this or if you did, I missed it. When you look at your EBIT ranges for 2021, can you just give a little color on what you're assuming on comps? And then I guess following on that is when we think in history of food retailers, when you're lapping very high comps, retailers tend to get irrational, irrespective of whether they should or shouldn't. So how are you thinking about the competitive landscape next year as all of you lap these unusually high comps? And then I had 1 quick follow-up.

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

Sure. Karen, we -- clearly, we scratch our heads and talk about what's going to happen next year a lot in terms of the macro environment. And there was some extraordinary March, April, June times in terms of comps across the industry. And clearly, lapping those -- I think it's going to be -- I think it's going to be more rational because it's so extreme what happened last year. If I'm or the year we're in at the moment, what happened earlier on in the year. I think they will be more rational because you aren't in that normal environment, Karen where you get a great number and then you think how am I going to lap it? I think most retailers will be -- particularly food retailers will be taking the view, that was extraordinary. And lapping that is going to be unrealistic without killing any sense of profitability, and I'm talking about other people in this conversation here.

With regard to us, we talked about this long before the pandemic. And we're going to be talking about it long after the pandemic. How do we target our customers and how do we play our own game. And that will deliver substantial growth for us going forward. The combination of new stores, e-commerce and in-store comp. We're very confident as we work the tactics through that we've got a long-term runway of growth in our business. How that works within the environment, we'll be being rational, and we'll be playing our own game as we target our customers that are very in tune with the proposition that we're putting in front of them. And we do believe we're very different to a normal food grocery retailer, who you would be traditionally seeing could affect us if there's an irrational environment.

So one, I think the rate environment will be rational. If it's not, we're going to keep playing our own game. Because we're pretty confident that, that's the right place for us to be. And there's plenty of opportunities for us to grow our business, whether it be rational or irrational in the marketplace as we play our own game as I say.

Operator

Thank you. I will now turn the call back over to CEO.

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

Sorry.

Operator

I will now turn the call back over to CEO, Jack Sinclair, for any closing remarks.

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

Thanks, ever so much, guys for spending some time listening to us this afternoon. We really appreciate your interest in our company. It's an exciting place to be at the moment. We're really thrilled with the opportunity that's in front of us here at Sprouts. And I appreciate you taking some time. And please stay safe and look after yourselves, guys. Thanks ever so much.

Operator

Ladies and gentlemen, thanks for participating in today's conference. This does conclude the program, and you may now disconnect.

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