REFINITIV STREETEVENTS

EDITED TRANSCRIPT

SFM.OQ - Sprouts Farmers Market Inc at Stephens NASH Investment Conference (Virtual)

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CORPORATE PARTICIPANTS

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

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

CONFERENCE CALL PARTICIPANTS

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

PRESENTATION

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

Okay. Thanks, everybody, for joining us this morning. I think we'll go ahead and kick things off. I'm Ben Bienvenu, I'll cover the grocery and convenience store industry here at Stephens. Sprouts is here with us today to talk about their business. As many of you know, Sprouts is a leading specialty grocer operating in the midst of what's been a dynamic year to say those believe it as a result of COVID. And the company is making solid progress in its strategic transformation that we think is poised to unlock incremental earnings power and create long-term runway for organic growth down the road.

And I'm delighted to introduce from the team, Jack Sinclair, Chief Executive Officer; Denise Paulonis, Chief Financial Officer; and Susannah Livingston, Director of Investor Relations. This will be a fireside chat format. I'll be leading the Q&A session today. But to listeners, feel free to submit questions, and I'd be happy to ask them on your behalf. Jack, Denise, Susannah, thanks so much for being here. I appreciate it. And Jack, I appreciate the solidarity with the Razorback flag in the background.

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

No hugs. So do you want to call the hugs or that might be a bit intimidating for us?

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

That might be off-putting, I think, but I like the idea.

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

Yes.

QUESTIONS AND ANSWERS

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

So needless to say, this has been an unprecedented period of demand for your business. And you've also been in the midst of implementing a strategic shift at Sprouts. So I'd be curious to hear your perspective on -- in the midst of this environment, how do you separate the signal from the noise in a market like we've seen in 2020 and assess the success of the transformation that's been underway.

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

Yes. I think it's a great -- one of the things that I'm kind of maybe in the context of the pandemic, we were -- or I was lucky in some ways in that we were able to set the strategy up and the direction before the pandemic hit. So it wasn't like we were trying to work it on the fly. I've been here now about nearly over a nearly 1.5 years now when I think about it.

And that in that first few months, we were able to get the strategy in place, real clarity of who customers who were targeting the supply chain strategy, format strategy, promotional strategy. And we had really good dialogue with the Board, and the Board were very supportive of the direction that we were taking off and the fact that we had that up and running.

And then we got this crazy March, the end of March that happened for all of us that enabled us to just keep the direction that we had in place, which was being really clear about who our customers were, being really clear about how we were going to promote. And from the outset, this -- the opportunity that we have here is we can generate the returns back to the kind of returns that this business was operating to when it first started off. So from a financial point of view, I saw a lot of opportunity, particularly around the promotional strategy.

And a lot of my heritage has been around being very consistent about pricing rather than being up and down and up and down, which created a lot of challenges, both execution wise and a lot for the stores and the distribution centers and challenges in terms of managing the margin. So getting that under control early, I think gave us an opportunity to then underpin the rest of the strategy from there.

And then since the pandemic has evolved, it's been a very different geographies have a different effects, different timings have different effects. So being really tight and close to the dynamics that have been playing out as they play out again yesterday in New Mexico, over the weekend and different things happening all the time in our business.

The one thing I think we've managed to get the team very clear on. And eventually, we'll get hopefully all the investment community clear about where we're going, is that consistency of here's our promotion strategy, here's where how our stores are going to build, here's how the margin profile will emerge and develop going forward.

And I'm excited about some of the supply chain things we're doing going forward as well. So there's a nice runway ahead. I think we've been able to balance the question that you asked, I think we've been able to balance this kind of keep into our strategy while managing in a very volatile environment.

And that volatile environment, the primary thing that I worry about every morning when I come in is how many people have caught COVID? How many -- how can we protect people better? How can we look after our people? And that's something that is constantly at the forefront of the management team in terms of how we can do that. That's probably the biggest priority we have at the moment.

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

Yes, understandable. In the midst of this environment, you picked up a lot of new customers during this pandemic. I'd love to hear what you guys are laser-focused on when you think about retaining those customers? And as we think into next year, when you think about budgeting, what's a reasonable goal of retention where you feel like you would have been successful in retaining customers relative to your expectations?

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

Well, regarding customers, we're very much focused on segmenting the customer base that we are looking at. So the U.S. food industry's retail is worth about $1.3 trillion, $1.4 trillion. We've narrowed our focus to about $200 billion of that, the focus around healthy enthusiasts and innovation seekers.

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And that's a chunk of the business that when we ask and look at these people that are shopping with us that look like that the Net Promoter Score that we get from those guys is off the charts good. I mean, as good as it gets in the industry, there's 1 guy who I admire greatly, who is kind of a point ahead of us, but we're right up there at the very top of Net Promoter scores, certainly the best that I've been associated with in my career.

And that gives us a lot of confidence that if we get our marketing right, that the communication to those customers that aren't shopping with us at the moment, primarily because they don't know us. Of the names at the top of that Net Promoter Score list, we are unknown. People don't know who we are. I suspect partly because of our geography, partly because of how we've evolved and developed. We're not those iconic names that people know of retail across the country. And we are in that space of having that huge white space in a marketing sense to make this thing come alive. Because what we do is very unique and very different. So the marketing initiative around where goodness grows, which we've kicked off. And we had to suspend that a bit because of the election and it was going to cost too much money to get into the big media spend. That's going to give us -- that campaign is going to start painting the picture much clearly, more clearly to the customers that we're targeting. With regard to the question, we've seen a lot of volatility in transactions since March.

That kind of -- the people that love us is very consistent, but there's some volatility around people are at different geographies having different volatility. And there's no question that the number of visits that customers are making to stores is going down because of the pandemic, the number of different locations they go. And that's not a situation that's naturally in our favor because we're not a business that's going to be able to supply everybody's needs. We're not in that consumable space that's been so dominant for some of the other guys in the industry.

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

Yes. When you think about your business in a post-COVID world, I know for all of us, that feels like a long way away. But I think understandably, there's a good deal of hand ringing from investors about both -- the question that we asked about revenue retention, but also just lingering costs of doing business. And I'm curious, though, what you see as some of the opportunities for your business in a post-COVID world that just might not have existed otherwise?

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

Yes. I think the dynamics that may have changed that might be consistent going forward -- might actually have relevance and salience going forward.

I think 1 e-commerce and grocery is probably something that has had us -- when I first took it maybe, we were at 3%, 4% of our business in that space. That's gone up substantially as you've seen from our latest numbers. That will drop down a little bit, but it wouldn't drop down all the way back to where it was. And I think that will be true as a trend across the industry. I think it's less prevalent in Fresh going forward because I think people -- although Fresh has evolved a bit, it's not the same -- it's not going to be the same drive as it will be in the rest of food. And we've been talking to some retailers in China and Italy, and the trends are interesting, and we'll have to watch that one going forward. And we're trying to be well placed in that space.

Food away from home, I think that's something that clearly has had a big impact over the last few months. Restaurants closing, opening, half opening, not open, that dynamic is going to be something that I think people might eat more at home for a little while. It will take 2 or 3 years for it to go back to where it was. So I think there'll be that trend for a little while. I think it will go back in the end to that.

So the 2 big things for me are e-commerce and food at home and how that's going to evolve and develop. And we probably have to make sure we're thinking hard about how that will work. The other part of this is how immunity and how people are thinking about immunity.

I think it's going to have a fairly big impact on the vitamins and in supplements businesses, how people choose to engage. We've seen big upticks in things like organics and big upticks in grass-feds and big upticks in our vitamins business. I think people will be thinking more about immunity ongoing after the pandemic.

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So those are the kind of 3 things that we think will probably still be relevant going forward. And it plays well to our produce strength. It plays well to our organic strength. Plays well to a lot of our health trends in the grocery fixtures, keto and paleo, and diets, and sensitivity to immunity. I think those are the kind of dynamics that we think will play forward. And there's probably some benefits for our brand in that and some kind of things that are neutral going forward as well.

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

Yes. Okay. I think when we think about COVID.

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

So it has to be costs -- maybe, Denise, you could just highlight a little bit about the ongoing cost to this.

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

Sure. So I guess just to finish it out, when we think about the business, we're very focused on safety. And so we do expect that there's no momentary change in the need for PPE and cleaning. We think that's going to be just an ongoing need for the business. We're also watching fixed time, right? We have to take care of our employees, and there's a lot more employees that have the need for fixed times when they become exposed and things like that. So we think costs like that will likely continue for the foreseeable future. The one change that we've made is we have returned to our regular bonus program. So we have a pretty unique bonus program where everyone in our store is eligible for quarterly bonuses, not just the store manager. And so what we've really done is focused back on that, focuses back on store performance, and stepped a little bit away from the above and beyond bonuses that were being paid in addition to the regular bonus.

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

Okay. Great. I think when I think about some of the elements of your strategic plan, I'm sure COVID has accelerated or slowed down certain components of that. When I think about the things that have accelerated, I'm sure digital engagement and the platform, the acceleration of the e-commerce business, acceleration of digital marketing pivot, the promotional strategy even. I'm sure there's also some elements of it that have slowed down. I'd be curious that has been slowed down by the COVID. I'm curious if you could kind of compartmentalize those components of your strategy and how COVID has sped up or slowed down various aspects of it?

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

Yes. Jack, I'll start, or do you want to start?

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

Yes. You start now, I'll follow-up. Good, thanks, Denise.

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

Yes. I think what I would say overall is, in some ways, COVID has accelerated our plan. So the big acceleration has come with all the things that you just mentioned. So our shift from print to digital, some of our ability to move a little quicker on some of the promotional changes that we wanted to make. And so that future margin growth that we always have embedded in our financials, I think we likely pulled forward a bit, which is great news for us. It gives us great cash to be doing all the other pieces and parts we wanted to do.

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The piece that I might say is not necessarily slowed down but evolving a little differently than we would have thought would be our new store growth program. So we're still on track for good new stores coming out in 2021 and beyond. But that work with developers, that work on the real estate side. It's a little bit more slowly with the pandemic behavior, even though you see other store closures and potential available in real estate, it just evolves a little slower.

Jack, would you add anything?

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

No. And I think just reinforcing that a little bit. I'm really pleased with the work we've done in new stores in terms of being really focused on the customer segmentation around the catchment areas that we're looking at. So we've done a really nice job on that. I think I could take you to every MSA in the nation and say where we should be building stores. And we've been really clear about which MSAs around our distribution centers need stores. The speed at which we've been able to roll that program out is probably going to -- we're probably about 6 months behind where I'd like to have been in that 3, 4, 5, 6 months, something like that, behind, where we might have been.

But that's kind of given us a little pause to get the format right as well. And I'm excited about some of the work we're doing in terms of making the smaller stores come alive, and you'll see that sort of in the springtime next year, which I'm excited about. And certainly, the acceleration we were sending out, we're now right here, we were sending out 21 million, 22 million flyers every week. We're now doing none. That kind of change is a pretty dramatic change, and that wouldn't have happened as fast if it hadn't been for the pandemic.

So our margins have probably moved a little bit faster than they would have done. But directionally, nothing's really changed this. The question is a good one. There are certain things going a bit faster and certain things got a bit slower.

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

Yes. You touched on the store growth, Denise and Jack, I appreciate that. I think that the average store growth profile of Sprouts is something that's been attractive for investors in the past. It underpins a really attractive organic growth story and creates this foundation for steady growth. That's an element of the strategy reaccelerating store growth.

Can you help us think of some of the things we should be mindful of as you work around reaccelerating store growth? What's different? What's the same? I know focusing on some concentration versus spreading out one of the elements that you're focused on, but would love to hear you elaborate on that front.

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

Yes. I think there's kind of 2 or 3 things, and I'll let Denise build on it as well. First and foremost, we're building stores around our supply chain network. In fresh foods, when we've got such a big proportion of our business, which is fresh, produce is our mainstay in the drive of the business. When you're driving too far with the product, freshness is compromised a little bit. And what I felt was that we're trying to build -- we were trying to build stores where there's definitely customers but trying to stretch the supply chain too far. And then so -- and there's some good examples of that, driving from Atlanta to Naples, it's a long way, driving from San Francisco to Seattle, it's a long way. So we have driving from Arizona to Colorado. I've been in America long enough to figure out it takes a long time to drive from Arizona to Colorado. So the kind of -- the context of what we started with is let's have a supply chain that allows us to be within 250 miles of our distribution centers. So we've got a new one being built in Colorado to deal with that issue that I've just talked about, which is going to allow us to supply our stores in Colorado and Nevada up there.

And that will be open in March. We're building a distribution center in Orlando, Florida, as we speak, and that will be ready in May, June time. I hope I'm just committed to some dates there. Denise, but I'm sure we'll be okay.

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

We were generally saying the first half of the year, but now we're nailed down, Jack. Good job.

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

In this COVID world, she can't kick me when I say things like that, which is quite entertaining. So the Florida, DC, and the Colorado, DC will deal with a lot of the challenges. And then we're looking to put another 1 in the Mid-Atlantic in Virginia or something like that to deal with some of the opportunities that exist over there.

So first and foremost, new stores scheduled around the distribution center, and the real estate team are only looking for stores within 250 miles of our 8 or 9 depending when we are the Mid-Atlantic one going. That one will be -- that's the program that they're working on. And that's a significant change from where we were in terms of thinking that one through.

Secondly, we're looking very hard at building smaller stores. I was -- when I first started, I spent a lot of time down in San Diego, where the original stores that kind of was the embryo of the whole thing, they all came together. And they're much smaller, and they're actually much more like a farmer's market, they're much more profitable, they cost less to build and they make -- if you can hold the kind of sales number, you can actually operate at a little bit lower sales and make them very, very successful.

So in terms of returns, our businesses -- our stores were getting a little bit big and a little bit expensive. And we've been taking a little bit of capital. We'll be able to build our stores around 18%, 20% cheaper going forward, which gives us a lot of scope to be very focused on the customers in that area and create that feel of a farmers' market and those stores will have a lot of focus on innovation.

15%, 20% of the products we sell will be different from 1 month to the next. So you create an environment will strengthen our whole plant-based proposition, which has been growing dramatically and doing very well for us. So we'll create a feeling of a farmers' market in a much smaller environment. So those 2 things, smaller stores, and stores centered around a supply chain strategy that's clearer. So -- I like to have both the profitability of the business and the strength of our proposition to that target customers. Is there anything you'd add to that, Denise?

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

I think I'd just add 2 small things, which is -- I think you talked a lot about the movement to the smaller stores. I want to be clear because we get this question from -- that's a lot. It's not about reducing the selling space in the store, it's actually about as Jack said, go back to the older format, which is we don't need as much backroom space. We don't need an eat-in area for customers, right?

We added space to make it feel like a bigger store, but not necessarily more selling square footage. That's where we're really coming back. So when we talk about being able to kind of maintain the level of sales you see in the existing store. It's a point that I think comes up quite a bit, and we wanted to reinforce. And then one that's a little lesser-known that I would just add is you might remember that in the old world when we opened a new store, we did it with a really big bet. So went really deep for weeks on end which could be great for that new customer attraction. But when you think about the natural ramp and flywheel that would come from comp sales growth year-over-year, when you did such that deep investment when you first opened that store, the model coming at turned upside down. And so what we've been doing this year already, and we'll continue as we go forward, is open with great promotion, great activity to get people excited about the store but not do the prolonged kind of opening the way we did in the past, which really challenge comps from the next year.

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

Yes. Yes, that's great. Denise, you touched on this earlier as it relates to your special -- your employee incentive programs that are unique to you all. I'm curious so as we've been in this environment of elevated sales and the impetus to provide elevated bonus incentives to your employees

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deservingly, kind of what's the paradigm that you're using or thinking about around employee bonuses and increased pay during this time period? What's the lens you're looking for to think about making those decisions?

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

Yes. So I can jump-in or Jack can -- and Jack, please pile on here. Overall, I think our philosophy has always been to really reward and pay for performance. To be really competitive in the marketplaces in which we compete to have that benefit be available. Something that's really new that since Jack had come to the company was moving to a quarterly bonus structure for the stores, where all team members are eligible, which really creates that vested interest for folks in the stores. When we've recently also moved to a 6-month review period. So people have an opportunity earlier in their tenure to have wage reviews, to have opportunities to move up in the organization.

So our overall philosophy is our store team members are our stores. They are our company. And making sure that they are appropriately rewarded is the primary focus. We want to do that through how we think about paying them every day rather than there necessarily being just be focused on food.

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

Yes. And I think one of the things that's been very clear this year, and it's been quite heartwarming is the fact that people working in grocery stores and people working in Sprouts the regard with which they're being held by the communities that they serve, has been transformed. It's very heartwarming when you see some of the cards and letters and what -- it will be a plan across the industry. This isn't just right. The way the customers across grocery have been kind of reacting to this kind of frontline worker almost and the support that they've had it's been very encouraging.

On the other hand -- on the other side of that, people are coming to work and they're kind of frightened to be quite honest about, especially in the early days of this pandemic exactly what does it mean being in front of so many people. And that whole PPE and the protection and the cleanliness and the hygiene has put a lot of pressure on our teams as well.

So this year, we have focused very hard on making sure. I think we always should and always would, but we focused very hard on making sure that as best we can, we take care of them, how best we can we compensate people appropriately within the context of the world that we're living in. Going forward, one of the strength of our NPS scores are the interface that our teams have with the -- with our customers. Specialty areas like vitamins or vitamin leads and the people working in those departments have become quite a trusted source for people in the context of this. That building up of service and the interface of how customers are interacting with our people, whether it be at the butchery counter, whether it be in the vitamin department, whether it's talking to the guys in the produce department, whether it's getting guidance on diets and those kind of things, that's an important part of our proposition.

And we're going to evolve and develop how we can incentivize people to be really good at that kind of side of things as we evolve through this. I think we've done a pretty good job this year at doing what we've had to do in difficult circumstances. But the longer term principles, as Denise said, talk about how do we get real buy in to what we're trying to achieve. And again, when you talk to our people, and I've been encouraged by this. There's a sense of pride in what we do and that it's more than just a job. And we need to kind of keep reinforcing that in the work that we're doing.

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

I think a lot of investors are focused on the difficult comparisons coming in 2021. For better or worse, that's the nature of the narrative. Not knowing what the top-line will do next year. Facing uncertainties in the macro environment and facing the difficult comparisons. I'm curious with what's in your control. I'm curious what you can control on margins? How you think about your margins? And how they react in a potentially negative same-store sales growth environment? Just given the large numbers that you do have to lap. What do you think about in terms of alleviating the concerns of lapping over those numbers?

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

Yes. And I think, first of all, I'd say we're not lapping over as big numbers as everybody else are, as everyone keeps telling us. So we kind of like got that. We know that fundamental starting point because of the nature of our business, because of social distancing. We've seen -- we saw a really big peak in the March, April time, as you can imagine. But as you saw, it kind of leveled off a little bit more so for us than others.

And that's kind of what we half expected. We weren't totally surprised.

What will happen going forward, we don't have as much to lap. That's all I'd say to start with. That's one. What's going to happen overall? We've got -- it will be -- I don't know when the pandemic is going to end. I don't know when the vaccine is going to come through. So I don't think -- it would be lovely if January 1, 2021, we just -- that all ended and we could just measure exactly what happens. That's clearly not the way it's going to flow through.

So our challenge will be taking control, as you say, of the things we've got control of, the cost of running our business and our margins. We had those margin plans well in place before the pandemic, though they have built up over. And we're seeing a lot of progress on that. We will see further progress on that when we get the program and -- when we get the new DCs up and running, distribution costs will be coming down a little bit. Shrink cost will be coming down a little bit.

So we've got some opportunities to continue to expand our margins and irrespective of what happens in terms of the top-line. And we're feeling confident about a lot of the work that's coming together on that in terms of some systems from replenishment and some work that's happening in the stores. So we see shrink and distribution costs continue to enhancing our margin.

What we're finding with regard to -- that creates -- in my estimation, some arrows in our quiver, if that's the way to put it. That as we evolve through the dynamics of as things change, I want to invest in our customers that we're targeting and the marketing initiatives, really talking to the customers that are relevant to our proposition irrespective of how they're choosing to, with how many stores they're going to or how they're shopping and how -- what's happening to restaurants, we can market very effectively to that target customer.

And we're going to have the resources to be able to do that effectively. What we're not going to do, pre-pandemic, during the pandemic, post the pandemic is chase promotional activity because it -- fundamentally that plays into a scale conversation that we're not going to win. And I don't want to win a promotional battle. If we do win it, we won't do it at the kind of returns that we need to make. And that's one of the fundamental changes that are consistent pre, during, and post the pandemic.

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

Yes. We touched on this earlier when we were talking about how COVID has impacted various elements of your plan, but clear is that the obvious impact on your business has been the online and digital business. We've seen that scale, accelerate tremendously.

How big do you think that business can get? Because I think we've all kind of reassessed how big we thought online grocery could be given this environment, customer behavior has changed tremendously. And how do you think about the profits of that revenue stream versus your in-store business? Can we reach scale parity at scale? What's the balance there?

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

I'll let you take that to start with Denise, and then I'll going to come in.

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

Sure. So overall, you ask a great question. I think your answer would be as accurate as my answer might be about where will this go over time. Do we believe it will continue to grow because people have figured out, it actually works. Sure. Is it likely to continue to accelerate at the pace we saw with COVID? I don't think any of us believe that. And just even watching other countries who are a little ahead of us in the pandemic. Things have leveled off a bit. But you raised a couple of other good points. It's a really important part of our business. And fundamentally, we want to serve our customers, however, they want to be served.

And for us, that just means we need to make this piece of the business as exciting to the customers coming into the store in the way that we can do that. When we talk about profitability and what we can do, the biggest thing I'd point to is think about the profit that we've generated this year, the margins we've been able to have this year, and we've expanded that business from 4% of our business to over 10% of our business. So while, of course, there are some extra costs associated with manning that business, it's usually also large baskets, large baskets with less promotional items in them.

So there's a healthy offset in terms of the mix of how that business comes through that we think makes it very viable to continue to increase penetration over time, but we still believe the vast majority of people will want to be doing some or all of their grocery shopping in a store because, in a store like Sprouts, it's just a great experience, and it's an easy in and out, and you get to do a bit of treasure hunting as you're there. So I think very focused on growing it, growing as profitably, but being where the customer wants us to be.

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

Yes. And I think just reinforcing that mix point. I think what happens in -- from a profitability point of view, the mix in our business whatever people buy, it's a fairly consistent margin because of the nature of our kind of proposition.

When you go and look at the grocery baskets of more traditional grocers on online, you see this huge disparity in make margin mix and that the high-volume consumable items, the CPG items tend to be at lower margins. And then the basket has to be made up by higher margins to make the thing work. We're not in that place. Our underlying margin profile works pretty well in that.

So then I think we have to, as Denise said, we have to meet the customer where the customer want us to be. But fresh foods is a dynamic that ultimately, I think people want to migrate more in fresh foods to go into the physical buying the product themselves and experiencing the smells and the colors and that's what our proposition has always been built on. And I think in e-commerce, for grocery, you'll see a very significant holding of the volumes on CPG items, big brands, consumable items, more so than you'll see what's happening in fresh foods.

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

Yes. Along those lines, you talked about people wanting to come into the store. Pickup is an offer, an interface for customers that's grown tremendously across the industry. Your model is a little bit different, but you're doing some pickup as well. How does that fit into your suite of offerings? What do you think in customer engagement looks like with that post-pandemic and over the intermediate to long-term?

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

Yes. Well, again, when the pandemic started, we were at 55 stores in terms of pickup, and it was a pretty low percentage of our business. We immediately ramped it up, and the team did a really nice job of ramping up to all stores within a few weeks. We had managed to do that in 6 or 7 weeks. So we gave the option to the customer to pick up given the context of the pandemic, and we have seen a decent business on it over the -- as part of our e-commerce business.

And I think it clearly was the right thing to do to give customers that option in terms of working it through, and we will continue to offer that option going forward as part of our proposition so that we can meet the customer where they want to be met in this context.

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The difference between us and pick up at some of the larger big box stores or the big is that people are not buying all their consumables, the big high weight things, big boxes of Coca-Cola and Keurig all those kind of things. They're not buying that in the kind of scale paper toes and they're not buying it in that kind of scale in our organization. So pickup will never be as -- I think it's going to be much bigger for some of these other guys, but it will never be as big for us.

Ultimately, that's not how our customer shops with us. But in the context of the pandemic, we have found that having that offer has been important for our customers. And I think, ultimately, that one, I don't think will be as important to us 2, 3 years down the line as maybe the e-com side of it might be. The delivery side of it might be, simply because of the nature of our small stores. And if you're going to drive up to pick up, I might as well going to see what they've got in terms of fresh foods. And I think that's what we're finding from people once you get past the pandemic.

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

Okay. Another element of your store and your historical build strategy has been deli, I think the deli interface has changed dramatically in the midst to COVID. You're talking about smaller stores, less seating, maybe no change in the selling space. How should we think about deli in the context of that new store and a new operating environment post-COVID.

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

Well, what happened in our business in our new stores and some of the new stores that we're still building, I think we're just about finished them now because of the gestation period in new store programs, have had a very, very big deli presence.

So we invested a lot of space and money on a deli island and a fairly substantial deli island with kind of a few seats, but it was kind of a halfway house to some of the great operators that do this well, and it was costing us a little bit of money. And the proposition, the products we were giving the customer was not substantially different. It was actually a much nicer environment. Customers liked it better. Not many people use the seats. They used to get the team on about how I could never find anybody sitting in the seats. But the island itself actually made the operating model more difficult because you couldn't access the production as easily. So you have to go back and forward. So it costs a little bit more money to operate. It costs a little bit more money to build. There were some nice bells and whistles on it, is the way I would describe them. But when you go back to our original stores, the deli business in, sandwich business in our San Diego stores are amazing, and we don't have these bells and whistles.

The meals that they prepare do really, really well in some of the smaller stores. So we think we can replicate this effectively by going back to what we've done in the past. We're doing a little bit more work on meals and creating meals, and that's something that we can get better at within the context of the format that we're developing. So as an important category. It is a category that legitimately the previous management of this business we're saying, we can do better in this because they go and visit some of these other guys.

But the outcome of it was not enough for additional product, higher costs, a little bit higher shrink, and higher operating costs, and higher capital costs. So I think we can evolve our way through this to be in a better place. There's clearly, as I said earlier, there's a dynamic post-COVID that I think will be more about eating at home rather than away from home. And we need to be -- we need to be well placed and probably better placed than we are today to deal with that.

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

Yes, okay. There's been so much noise in the financials of grocers, your peers. But I think kind of circling back to the start of the conversation, you guys are in the midst of a strategic transformation. You're doing a lot of different things. I know, Jack, you said it well. It's not like we're going to get to January 1 and all of a sudden, it's a new day, and everything is clean from a number standpoint, but when we try to contextualize your business relative to your peers and competing investments for buy siders, what is Sprouts growth algorithm? What should we be thinking about as a reasonable expectation for repeatable growth, growth algorithm over the next 3 to 5 years?

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

Well, we've got a 5-year plan. I don't know, Denise, if you want to have a go at that, and then I'll kind of build on it.

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

Sure. Yes. So I think go back to where Jack started at the beginning of the conversation, a blessing for us is we had had this strategy developed. We had had the strategy kind of ready to go out of the gate, pre the pandemic. And so I think the foundation of all of that remains intact and as does the growth algorithm. What is it uniquely different for us than many other players out there in the space is we do fundamentally believe in the white space opportunity of 10%-plus new store growth every year.

As Jack mentioned, when we find our target customers, they love us. We don't necessarily have enough points of distribution to reach as many of them as we could possibly reach. And so that new store growth potential is a very real part of our equation. We think modest continued comp growth. We would love that to be faster. We'll work for that to be faster with our target customers, but our financials are really great, geared around low single-digit comps in a normal environment.

And then the improvement in the 4-wall box economics that we've talked about. So fundamentally, these smaller stores can be more profitable stores.

They can be more profit-generating stores with a 20% lower size, 20% lower cost to build and operate that promotes a great financial return. I think the piece that might be a little bit accelerated and different than what we talked about when we originally rolled out the strategies. I think we have done a step-changing where we are with our margins. And so fundamentally, we said we were going to grow them over time. I think we've been able to show that we can do that and in fact, accelerate that. So the fundamentals of that growth algorithm in capturing the white space all remain intact. We'll complement that nicely with e-commerce where the customer wants to be served, but the core model really still intact.

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

Yes. And I think that if I had an aspiration, I'd like the investment community to kind of view as different from our -- even the word peers, I keep saying, Denise, I just don't see ourselves as the same as the people that are calling our peers. And it's not in any way kind of trying to be difficult. I just think it's a very different mix business when you've got produce is a big way, way over 25%.

You've got bulk, you've got vitamins, you've got meat, you've got as a quasi kind of unique specialty grocer that clearly can give significantly better returns than when you're trying to chase all of that $1.4 trillion marketplace.

Because when you do that, you have to chase everything. And if you're a big-box retailer or you're a big supermarket, you've got to chase everything. We are in a very unique position of being able to have a proposition that was so brilliantly evolved by the guys that invented this whole thing and made it all come alive.

We've got this opportunity of being very distinctive and very unique, and I think a very unique investment proposition. So my -- again, my aspiration is that we don't get compared to peers because we don't have any peers. We're just Sprouts.

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

That's a good place to leave it. Jack, Denise, Susannah, thanks for your time today. Thanks, everybody, for listening. Have a good rest of the day, rest of the week, and Happy Thanksgiving to everyone.

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

Thank you.

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

Thanks very much. Take care, everyone.

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