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SFM.OQ - Q1 2021 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 1Q21 net sales of $1.6b, adjusted earnings before interest and taxes of $113m and adjusted diluted EPS of $0.70. Expects FY21 net sales to be flat to up slightly and adjusted diluted EPS to be $1.87-2.00.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Sprouts Farmers Market First Quarter 2021 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand conference over to your speaker for today, Susannah Livingston. You may begin.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our first quarter 2021 earnings call. Jack Sinclair, Chief Executive Officer; and Denise Paulonis, Chief Financial Officer, are with me today.

The earnings release announcing our first quarter 2021 results, the webcast of this call and quarterly slides can be accessed through the Investor Relations section of our website at investors.sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding our expectations for 2021 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 the commentary on forward-looking statements at the end of our release -- 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. With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today. I'm very pleased with how we have navigated the current environment as we begin to cycle some of the positive impacts from the onset of the COVID pandemic last year. Combining our strong financial performance with the strategic opportunities ahead of us makes me very optimistic about the future of Sprouts.

For the first quarter, we generated diluted EPS of $0.70, up 52% from the first quarter of 2019 as our strategic initiatives and promotions and shrink continue to deliver strong, sustainable financial results. As I've stated before, I believe 2020 was a turning point for Sprouts, and we're continuing to build on that success and momentum this year.

For 2021, our focus remains winning with our target customers by building our brand through meaningful marketing in and out of the store, curated merchandise, building an efficient supply chain and unit growth supported by our new format to further expand our reach.

2020 was a pivotal year, not just for Sprouts, but for Americans, in general, as we all tried to stay healthy. As we kick off a new year, the same focus on health is top of mind. For Sprouts, this plays well into who we are: fresh, natural and organic specialty retailer. Fresh produce has always been the mainstay of Sprouts, and it continues to be at of our proposition, representing 22% of our business. In addition, what sets us apart from other grocers is the breadth of attribute-based products that we carry. Attribute-based trends like keto, paleo, organic, plant-based, gluten-free and functional are all themes focused on wellness and play directly to our target customers.

In 2020, our organic sales across the store increased 21% to $1.4 billion. And in produce, Organic sales were up 23% driven by the desire to eat healthier. We're becoming the leader in the attribute space joined by our pioneering vendor community. Becoming the destination for up-and-coming vendors in the food industry is a fundamental part of our merchandising strategy and something our target customer desires. We like to lean in and take risk on these young companies. No one else is collaborating with our teams like we are. We help drive their innovation and improve their ingredient panels, which results in exclusive market entries with leading-edge products for Sprouts.

Nutpods Creamer is one such example. We started partnering with them back in 2018 as a small women-owned company. Over the years, we have partnered to create first-to-market flavors and value-sized offerings. And this week, a new zero-sugar sweetened option will be in our stores. The growth we have seen in Nutpods and many others have been extraordinary, and we look forward to how much more we can do.

In the long run, these relationships are creating a product innovation pipeline to keep our shelves full of unique, trending merchandise. As I've said before and we'll continue to see, we are not a traditional grocer. And as we grow in scale, we're evolving as a go-to food retailer for natural, organic and attribute-based partnerships and product releases.

In the first quarter, as in quarters past, attribute-led product offering drove revenue. The plant-based trend is one such offering that we continue to expand on our shelves. For example, Take Two milk alternative made from rejuvenated barley and Brave Robot dairy-free ice cream are 2 products that helped drive sales in dairy and frozen.

Both deli and bakery continued to grow on top of last year's COVID run-up, fueled, in part, by innovation as well, like Sweet Earth plant-based chicken alternative meals in deli and strength from seasonal offerings and keto-based products in baking.

In grocery, the team continued to drive forward our innovation pipeline, resulting in more than 400 new items in the first quarter with still more to come this year. Many of these new products were the result of strategy work performed in 2020 to better serve our target customers. Throughout this year, we will bring even more new products to create that treasure hunt shopping experience, and we'll be highlighting these new items in our innovation centers, in our new stores and our find a new favorite merchandising displays throughout all stores.

Moving on to our brand. Though we have 362 stores across the country, we are behind from a brand recognition perspective. Our awareness is very low. In 2021, this will change. Our Where Goodness Grows campaign was kicked off late last year with our first (inaudible) TV and many other digital [viewership]. This year, the brand changes will start to come alive in the physical assets, starting with our 5 new format stores. Eventually, they will be reflected in our product offering through a common design principle completing the entire umbrella of the Sprouts brand.

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On the marketing front, our digital-first initiatives designed to connect with more target customers continue to progress well. We're building our base of customers with e-mails up over 140% in the first quarter and website traffic growth of 39%. Importantly, e-mail subscribers tend to have larger baskets than other customers, which is one reason why we remain focused in growing this number over time. Through our marketing journey, we have identified who are our core customers, have begun to increase our digital communication and are starting to see this resonate with target customers. Through our data sources, we continue to see positive trends and data points, suggesting that we are winning disproportionately with our target customers.

As well, we continue to see customer counts improving, ending the quarter with the highest we have seen since last April when the pandemic set in. In addition, we noted in one of our customer surveys that the majority of our customers who reduced or eliminated trips to Sprouts during the pandemic expect to return post pandemic. These are all steps in the right direction for our marketing strategy, and we look forward to increased sales from these initiatives as the year progresses.

When I first joined Sprouts, I noted that our supply chain was disjointed with stores too far from our distribution centers. So I'm very excited about the opening of our fresh distribution center in Aurora, Colorado, serving 45 stores and bringing us to 6 DCs across the country. The opening went well, and we are now supplying all stores in our Colorado, Utah and New Mexico region, a testament to the strength of the team. This new DC, along with the new Florida DC to be opened this quarter, will create a faster supply chain and building our goal to add our DCs within a 250-mile radius of our stores. In addition, they will allow us to serve more stores and customers with fresher produce, aided with the benefit of ripening rooms and allowing us to support local farmers.

In season, our local produce offering in Colorado will increase by more than 4x our past assortment. The Colorado DC house produce from family-owned Strohauer Farms, who have been growing potatoes in Colorado since 1910; family-owned Petrocco Farms, only 30 minutes from our DC, who grow everything from leafy greens to sweet corn and peppers; as well as Hazel Dell exotic organic mushrooms grown year-round in temperature-controlled sheds, among others. These farming relationships will expand with our new local sourcing team housed out of the DC with a wealth of experience in local sourcing.

This sourcing model is being replicated across all our distribution centers to ensure we are supplied with seasonal and locally relevant produce in every store.

With this initiative, we will also decrease the miles our trucks drive, therefore reducing our greenhouse gas emissions and creating operational efficiencies like less shrink and a reduction in food waste. I can unequivocally see this piece of our strategy is good for our customers, our business and our planet.

Our investments in 2021 go beyond the DCs. Considering we're a young company, we were only 54 stores a decade ago with opportunities to invest and upgrade our systems that support and drive our future growth. A few of the investments this year are focused on perpetual inventory, replenishment, computer-assisted ordering, labor management and a new human capital management system. These projects are intended to improve in stocks, improve our labor productivity and overall store conditions and provide team members with an efficient, modern HR access point.

As for unit growth, our pipeline remains strong with deals reaching out to 2024. As planned, we didn't open any stores in the first quarter as we were developing our new format. Continuing with our plan, we have one store scheduled to open in Q2. And as stated before, COVID pushed most of all -- most all of our openings to the back half of the year, and we remain on track to open approximately 20 new stores this year.

By the end of July, we will have 2 new format stores opened: a new store and one remodel of an existing store. In walking a virtual 3D rendition of the new store, consumers overwhelmingly gave positive marks on the low profile and overall feel while also rating the store better than the current store experience. As a reminder, this new format will have a smaller footprint but more selling space per square foot, costs 20% less to bills, and we expect to have similar sales to our boxes today, resulting in expected higher returns.

One last topic. Last week, we issued our 2020 environmental, social and governance report that highlights the tremendous work our team has accomplished during the year, bringing positive change to our nation's health, which goes well beyond the food we sell. From our response to the

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COVID-19 pandemic to our efforts to reduce our environmental footprint and improve the well-being of our many stakeholders. We've made great progress on our journey to improving our sustainability program. We've done great work reducing our climate impact by decreasing our normalized carbon emission on a square-foot basis, aided by our strategy to switch to digital marketing from print.

Our team's focus on waste production has reached a new milestone at almost 60% landfill diversion rate, rooted in our drive to increase food security for our communities who are donating an equivalent of 23 million meals to local food banks.

Developing the next generation of leaders to grow with Sprouts is of great importance to me and the future of Sprouts. In 2020, we promoted 7,200 team members, half of whom were ethnically diverse team members, and we've built 72% of store manager positions with internal candidates, ensuring, at Sprouts, you can create a career, not just a job. I encourage you to review all the details in the ESG report, which will give you good insight to the work we're doing. I'm very convinced we can do good by doing good for our customers and for all our stakeholders.

Before I hand it off to Denise, I want to acknowledge the incredible work the teams at the stores, DCs and in the support office continue to do week after week. They're driving customer engagement and sales supported by the depth of knowledge in the natural and organic space. As you've heard me state before, we're only in the early innings of our strategic changes with many improvements still to come. And yet one constant remains through the changes we have all gone through: People want healthy foods now more than ever, which is, at Sprouts, is all we do.

Now let me hand off to Denise to discuss our financials in more detail as well as our 2021 outlook. Denise?

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

Thanks, Jack, and good afternoon, everyone. For the first quarter, net sales decreased 4% to $1.6 billion, and comparable store sales were down 9.4% compared to the same period last year. Our year-over-year comparison is not a straightforward indication of growth. We believe it's important to focus our performance on a 2-year basis. To that end, our net sales were up 11% compared to the first quarter of 2019, and our 2-year comp stack was up 2.2%. After posting positive comps to start the quarter, as expected, same-store sales turned negative as we began to cycle the 2020 COVID impact, and reopening progressed. Importantly, towards the end of the first quarter and into the current quarter, we have seen a return to positive traffic.

Due to our ongoing strategic changes, even with some sales deleverage and record high e-commerce sales penetration, profitability remained strong with an adjusted EBIT margin of 7.2%, trending well ahead of our 5.7% margin in the first quarter of 2019.

As Jack mentioned, innovation continued to help drive our sales across many categories with deli and bakery notable winners. Offsetting this, we saw some sales pressure in vitamins due to a nonexistent cold and flu season. E-commerce sales continued to remain strong with sales up 221% compared to last year. For the quarter, e-commerce was 12.5% of sales, reflecting a notable increase in January as the country experienced a spike in COVID cases, settling back down to our fourth quarter 2020 levels by March. Clearly, the work done last year to create a full omnichannel experience by expanding pickup to every store, and the addition of shop at sprouts.com continues to resonate with our customers.

For the first quarter, gross profit was $586 million, and our gross margin was 37.2%, an increase of 114 basis points versus the first quarter of 2020. Efficient promotions and good everyday pricing as well as continued benefits from our ongoing shrink initiatives drove improvement. As a reminder, the first quarter included the annualization of the promotional changes we implemented in late Q1 and early Q2 last year.

SG&A costs increased $3 million to $440 million or 27.9% of sales, deleveraging 141 basis points compared to the same period last year. The majority of this deleverage was attributed to sales deleverage from cycle in the onset of COVID last year and increased e-commerce fees due to the higher omnichannel sales as more customers have continued to rely on home delivery and curbside pickup. As well, SG&A was impacted by additional COVID costs related to sick time and hero pay more than offset by lower bonus payouts versus last year.

For the quarter, our adjusted earnings before interest and taxes were $113 million, an increase of 41% when compared to the first quarter of 2019, a significant positive step change in performance that we will continue to build upon.

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Our interest expense was $3 million, and our effective tax rate was 25%.

First quarter diluted and adjusted diluted earnings per share were $0.70, up 52% from the first quarter of 2019. We continue to generate strong cash flow from operations, $105 million in the first quarter to fund future expansion and sales initiatives.

For the quarter, cash was impacted by higher bonus payout for a strong 2020 performance and an increase in inventory in preparation of opening the Colorado DC.

In the quarter, we invested $9 million in capital expenditures, net of landlord reimbursement, primarily for new stores.

Additionally, following the Board's approval of a share repurchase authorization in mid-March, we restarted our share buyback program, purchasing approximately $3 million in stock by the end of the first quarter. We continued share buybacks in the second quarter. And year-to-date through May 3, 2021, we've repurchased $5 million in stock under the current authorization.

We ended the quarter with $250 million outstanding on our revolver, $39 million of outstanding letters of credit, $256 million in cash and cash equivalents and $297 million available under our current $300 million share repurchase authorization.

Reflective of a strong balance sheet, we continue to maintain a low debt position, ending the quarter with a net debt-to-EBITDA ratio of nearly 0 at 0.01x.

Now let me provide an update on our 2021 outlook. The impact that the pandemic will have on the U.S. economy, food at-home demand and consumer habits is still in flux. And in turn, we continue to manage the business under a number of scenarios, creating a bit wider-than-typical range for our outlook. As a reminder, I'm giving these comparisons on a 52- to 52-week basis as fiscal 2020 was a 53-week year.

We continue to expect net sales to be flat to up slightly versus 2020 driven by unit growth of approximately 20 new stores, which will open in the back half of the year and comparable store sales down low to mid-single digits. As stated before, underpinning our assumptions are negative comps in the first and second quarter as we lapped the height of COVID with an improving 2-year comp sales stack each quarter.

Capital expenditures, net of landlord reimbursement, are expected to be in the range of $140 million to $160 million. We now expect our corporate tax rate to be approximately 25%. Due to slightly better performance in SG&A than expected in the first quarter, we are increasing our adjusted EBIT expectation by $10 million to be in the range of $305 million to $325 million and increasing our adjusted diluted earnings per share to be in the range of $1.87 to $2. We continue to expect to maintain a majority of the gross margin rate improvement we realized in 2020 with the first quarter experiencing outsized benefit and the remaining 3 quarters being pressured as we cycle some COVID benefits from shrink and buying opportunities we don't expect to repeat. We see several puts and takes for SG&A margin for the year with reduced expenses from bonus normalizing, mostly offset by annualized COVID-related costs, as well as increased health care costs and sales deleverage.

We have started 2021 on a good footing with a strong balance sheet, and I'm confident that the strategic changes we began last year structurally changed our financial algorithm for the long term.

At this time, we're happy to take your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Mark Carden with UBS.

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

Great. So on the comp, you were up 2.2% on a tier stack in a period where there were still some COVID restrictions in place. Now I know you guys don't sell as much as some of your competitors in the way of popular CPG products, but are there any other factors that we should be aware of on the top line that may have held you back? Was it mainly vitamin-driven? Are customers still consolidating trips to larger stores? Are you still adjusting to new strategy? Any color here would be great.

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

Well, you kind of answered the question there, Mark, and the things that you mentioned specifically to the first quarter. As we alluded, clearly, there's an overlap. Jan-Feb was a different overlap to March's overlap. But one of the things that would probably have been a factor that we didn't quite take into account was the vitamin growth that we would have expected from a cold and flu season in January, and that's something that probably didn't happen to the extent because everyone's wearing a mask and nobody had the flu. So that certainly made some impact on that in the early stages of the quarter.

And the reopening program and what's happened with regard to restaurants opening and not opening had some impact on us in the meat space and probably in the alcohol space as well a little bit, and that's something that certainly had an impact.

And as we've said all along in this dialogue around what's been happening over the -- through the pandemic is probably as people have reduced the number of places they go to do their food shopping that we didn't benefit from some of the growth that happened previously, and that's certainly something that continues. And at beginning, we think to kind of mitigate itself as we play through the year. We're certainly seeing some encouraging signs on our target customers with the intention that they're telling us that they're going to be more comfortable about going out and shopping in more places, and that's something that gives us a little bit of encouragement going forward.

I think there's pretty clear our healthy enthusiast target customers. We are probably more concerned about the pandemic and the implications for their health than maybe the average customer. And I think in some ways, I think that's why our e-commerce business is quite strong. And I think people that are more comfortable at going out, we're thinking there's some encouragement, going forward, in the data that we're seeing.

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

Great. That's helpful. And then we're hearing more about rising inflation in food. And I know Sprouts has historically had a bit of a different profile on this front. But how are you thinking about inflation over the course of the next few months? And does your new promotional strategy really change your thought process with respect to passing through any higher costs?

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

Certainly, what we're seeing -- as you know, our mix of business is different. And the -- and looking at the first quarter, our produce was actually deflationary, not inflationary in the first quarter a little bit, not hugely, but a little bit. And that's something that means that our mix going forward, we're actually anticipating the produce going forward because there's going to be pretty good yields and pretty strong opportunities for us to take advantage of price in the marketplace. So we're not as worried about inflation in our fresh produce business. Probably a little bit more worried about inflation, if worried is the right word, but a little bit more conscious of inflation in the meat space and 1 or 2 of the other parts of the grocery business. And we're watching that closely.

Transportation is clearly putting some pressure on the supply chain of our vendor base, and we're watching that closely. By and large, we're feeling pretty confident given that we sell a pretty differentiated range of products that as inflation plays -- and cost inflation plays into our business, we're feeling pretty confident that we can pass it on appropriately. If it gets too big, then we'll have to watch and have dialogue with our vendor base on it. But from what we're hearing so far and what's in front of us, we're feeling that we can pass it on and not have the kind of huge worry about what might happen going forward.

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Operator

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

Scott Andrew Mushkin - *R5 Capital LLC - Founder, Managing Partner, CEO & Director of Research*

So first one is a little bit along the same lines as the last one, but I wanted to broaden out a little bit about comps. The big thing that we hear from clients is like, hey, Sprouts is a good business. But let's face it, they just can't comp like they should. And the gross margin gains that they're seeing are not sustainable, that they're going to have to come in and lower pricing, and some of these earnings, really, is a little bit of a mirage that's why it trades so cheaply at the equity. What do you guys say to that? What's your rebuttal to that line of thinking?

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

Well, I think we -- Scott, we've been pretty -- so far, we've had very consistent record of delivering on that. So the sustainability, so far, quarter after quarter after quarter, we're feeling confident about that. We're certainly aware of why -- where the margins have come from. And partly, it's about the promotional unraveling of a very aggressive high-low promotional and actually negative profitability promotional. We're not going to bring those back, so I can kind of guarantee that, that mix that was driving a lot of the margin issues in the business has gone away and sustainably gone away.

We know we can improve -- continue to improve our strength. We're seeing that in our business week after week after week, so we're feeling very confident about the sustainability of that. And the fact that we're selling such differentiated product allows us to manage our EDLP pricing. As long as those products that we're selling are different, we are able to price it based on elasticity. And as long as that plays through and works out, and I'm pleased with some of the work we've been doing, the pricing team and the pricing systems we've been bringing in, is allowing us to give us a lot of confidence that there's sustainability in the gross margin and the sustainability in our operating margin.

And think about the other things that we're doing. The distribution costs should be coming down as we drive less miles to the stores. The operating ratios in our business should be kept on, although there are some labor pressures, the operating ratios. We're a fairly immature, young business. So the things that we're working on in terms of inventory management and operating the stores, self-checkout at the register, there's some sustainable operating improvements that we can -- that will drive -- help us drive bottom line. We've got sustainable logistics improvements that can help to drive bottom line, and we're pretty confident that -- well, when we know the promotions aren't coming back in any aggressive way on high-low promotions are aggressive, below-cost promotions. So you put that together, I'm certainly very -- if I'm confident about anything, I'm confident about the fact that our margin growth is sustainable.

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

Yes. And I think one piece I'd add on the customer front is we have been making a pivot with our strategy, and we knew that there would be some folks who might be more of a coupon profile that wouldn't be the ones that would stick with us. And the intent was to gain a lot more of our target customer going forward. And I think it's interesting that we've seen a couple of pieces of research that we've done that are pointing things in the right direction with some green shoots and that is all starting to resonate. And I'd say, first, we actually did research directly and people have told us that where they had reduced their shopping trips to Sprouts before because of the pandemic, but the majority of them have intent to return as the pandemic subsides. And we said that's great. But what's even better is that as we've come into April, we're starting to see this prove out a bit. So we ended the quarter with the highest customer counts we've seen since the start of the pandemic, so a nice positive direction and more customers starting to come into the store.

We're also seeing that customer count, in particular, with the reactivated and reacquired customers. So the same ones you told us they had stopped shopping with us because of the pandemic, we're starting to see those numbers trend up a bit.

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And then with the positive return to traffic, I think everybody was wondering, well, what will happen to basket. And we've been very pleased to see that while traffic has turned positive at the end of the quarter and into Q2, we're actually holding our basket pretty much in line with where we were coming through last year rather than there being a trade-off between that basket and traffic number.

So some positive indications there that the pivot and the strategy that we're making is starting to resonate. And hopefully, we'll be able to see that with a bit more clarity as some of the COVID haze subsides.

Scott Andrew Mushkin - *R5 Capital LLC - Founder, Managing Partner, CEO & Director of Research*

So that's really good color, guys. And I just had one follow-up question. I mean obviously your balance sheet is really good with not really any debt on it. You're producing free cash flow. And the stores crank-up doesn't really come to next year. Why not get more aggressive and just buy back a chunk of stock and say, "Hey, it's cheap. It's our best investment right now." I know you have a buyback, but it seems like you could do a lot more if you wanted.

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

Yes. I think we're really pleased that we have the authorization out there, and we do intend to utilize that authorization. I think we would all agree that we think that the stock has a lot of positives that it can run in the future years, and we'd like to get in on that, too. I think what really happened in the first quarter for us is that authorization got put in place fairly late in the quarter, and we were trading under a 10b5-1 plan, so you didn't see quite as much come through as we could have done. But we have all intent to be utilizing the authorization as the weeks and months here evolve.

Operator

Our next question comes from the line of Rupesh Parikh with Oppenheimer.

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

So I guess, Denise, just following up with your commentary on the, I guess, improving traffic lately. Is there a way to give more color on maybe the quarter-to-date competence or just any way to -- so we can be to understand the types of trends you guys are seeing in April?

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

Yes. I don't think we're going to call out any numbers because, as we know, week by week, there's a lot of volatility in what we're seeing. But I think there are some positives, specifically related to the target customer that we'd reiterate. So I think with our target customer in specific, they have a larger basket, and their basket has continued to increase more kind of post pandemic than that nontarget customer, suggesting innovation and other things in the store are resonating with them. And we have seen target customer retention turning higher and increasing over this period of time as well. So reasons to believe, particularly with those target customers, that the positive traffic turn and holding the basket is something that we will continue to see.

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

Okay. Great. Maybe just one follow-up question. On the SG&A line, I think last call, you mentioned that you expected SG&A dollars, I believe, to be roughly flat for the year. What's the right way to think about it now?

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

Yes. We generally -- actually, the gross -- we expect SG&A rate to be directionally flat for the year, and so that might be a little bit different in what you were hearing. But what we believe is we're going to continue to see benefit as we have bonus that's going to roll off and be a tailwind for us with, in turn, some additional expense as we continue to manage hero pay, health care expenses and then just some general sales deleverage. But the 2 of those every quarter won't necessarily be flat, but we'd expect the year will be approximately flat.

Operator

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

Thomas Hinsdale Palmer - *JPMorgan Chase & Co, Research Division - Analyst*

It's Tom Palmer on for Ken. First, just wanted to ask on the e-commerce side. Looks like penetration rates for you were still climbing. Do you expect this to continue as the year progresses, just because more stores offering services and the improved app? Or do you think we've reached a peak, and as you kind of reach reopening, that starts to ease a bit? And then alongside that, how has fulfillment been? Have you been figuring out ways to make it more efficient, kind of reduce the SG&A burden that it has put on your stores?

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

Yes. I'll let Denise talk a little bit about the cost side of this. In terms of the demand side of it, Tom, we're feeling that we probably have reached a peak on this. As I said a little bit earlier, I think a lot of -- we probably are one of the fastest-growing e-commerce businesses and grocery over the course of the last year or so. And that has probably been driven by the sensitivity of our customers going out. And they want access to this product, but they've had to use it through our e-commerce vehicles. And we expanded our pickup, which made a big difference, too. We were only in 55 stores for pick-up, and we expanded that to all 360 stores, as we've talked about in previous calls. So that's been a driver to our mix and a driver to the fact that we're growing faster than most in the space.

As this settles down, as people are more comfortable getting out, as the mask mandates change, as vaccination rolls out, we're expecting it to settle down. It won't settle all the way back down to 3.5%, where we were when I came in. I think it will settle back down, if I was guessing, somewhere around 8%, 10% of our business rather than significantly anywhere near where we're at, at the moment.

And in terms of how we -- we're specifically figuring out a way to try and minimize. Remember, it's all profitable for us. We're pretty pleased by the fact that it makes us money. The margin mix isn't quite as strong, as you know. So -- and we're doing some specific things to try and minimize the cost of that. We're handling all of the pickup at our store through our own labor, which is making a difference to that in terms of both the speed and efficiency of that and the cost of it. And we'll continue to look at that. I don't know if you want to expand on that a little bit, Denise.

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

Yes. And Jack, I think you covered a lot of the points. I think the point we'd reemphasize is even with that penetration at 12.5% in the first quarter, we delivered a strong operating margin, up substantially from where we were 2 years ago, where penetration was next to nothing.

And I think the other part that I'd mention as well is we continue to invest behind our owned channel, our shop at sprouts.com channel. And from a white label penetration, for lack of a better way to put it, is now up to about 17% of our total e-commerce sales. So as we're bringing those customers in a little closer to us, we have an opportunity to have more customer data, have a more direct relationship with those customers and to monetize that a little bit more than what we can simply do when we'd be selling through a marketplace. So we just reinforce the fact that, for us, it is a profitable business, and we have absorbed the costs in our P&L to date at a relatively high level of penetration. So everything here and working for, as Jack said, is efficiencies of picking ourselves in our stores, we'll only be able to build on that as we go forward and improve that profitability more.

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Thomas Hinsdale Palmer - *JPMorgan Chase & Co, Research Division - Analyst*

I wanted to ask just on the promotional environment. Obviously, the large pullback in promotional activity has really driven stronger margins over the past 1.5 years now. Is there a point where it makes sense to get more promotional as a way to drive traffic trends higher, not back to prior levels, but just higher than we've seen over the past few quarters? And at what point does that make sense, I guess?

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

Yes. I think it's a good question, Tom. As we continue to experiment with different ways to attract our target customers, our marketing activity and our promotional activity is very much geared to how do we communicate directly with our target customer. And we've been learning that.

Remember, traffic and transactions have been distorted pretty dramatically over the course of the last year or so. And as we work our way through different techniques that we can use, certainly product and price won't be the driver that's going to attract the customers that we're trying to attract. It's more likely to be technique to build loyalty amongst our target customer base, and we're getting increasingly -- we've done a lot of what we call test and learn through Q1, which we've learned some different techniques, some of which have worked and some of which haven't worked. And we're working our way through different techniques as to how we can drive that business but very focused on target customers as opposed to doing broad-brush product and price promotions. Because what we want to have is a really good value in our produce business, communicate that really strongly, communicate the benefits that we talked about in terms of our attribute-based products and drive people into the stores on the back of that.

And remember, our awareness is low. And the fact that awareness is low gives us a lot of comfort that if we really communicate the proposition effectively using the techniques that we're using. And we might have to spend a little bit more on marketing as opposed to on promotions going forward. But as I say, we're going through our test-and-learn phase, and we'll figure out the right way to handle it over the course of the next few quarters.

Operator

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

Renato Oscar Basanta - *Barclays Bank PLC, Research Division - Research Analyst*

This is actually Renato Basanta on for Karen. So my first question is sort of bigger picture and maybe a follow-up to Scott's question earlier. But right now, obviously, you had a lot of initiatives that are helping drive profitability, and those are certainly showing up in the numbers and are commendable. But one could argue that, at some point, those starts to dry up. So my question is how do you think about prioritizing profitability initiatives versus sales growth? Because I think, at some point, you're going to have to get that top line really going again to reach your longer-term objectives.

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

Well, the longer-term objectives in our business are fundamentally the growth plan that we've got in terms of new stores. It's going to give so much more access for our health enthusiast and innovation seeker customers to get access to the Sprouts proposition, which will -- is already pretty unique, and we're going to make it even more unique so that the specificity of why you come to Sprouts and who you are as a target customer is the focus of all our work, whether it be merchandising work, real estate work, marketing work. We're focusing it all on our target customers.

We know from all the data that we've done that there's plenty of people there who aren't spending the dollars that we'd like them to spend with us, partly because of awareness and partly as we work better to communicate effectively with those target customers. And it's very true in markets

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where we're not known. If you go to Florida or Texas or Baltimore where I was last week, you've got very different dynamics going on there as opposed to San Diego or Denver where we've already got a pretty strong presence.

So the focus of what -- the premise of the question is that we have to invest margin to get top line. We're not in that space. We're in the space of our proposition and the algorithm that Denise outlined in the remarks earlier. We've got an algorithm that gives us a strong underlying profitability. We've got customers out there that look like the customers that we want to attract, and it's up to us to do that effectively through communication, not through investing tons of money and margin. That's the reality of it, and we've got some maturity in our operating base that gives us even more comfort that, going forward, we can sustain the margins while attracting more of our target customers.

Renato Oscar Basanta - *Barclays Bank PLC, Research Division - Research Analyst*

Okay. That's helpful. And then just a question on the comp guidance. So a bit of a slowdown from a 2-year stack perspective in terms of comp for 1Q, and I presume some of that's due to California dining restrictions being lifted and maybe some of the other things you called out. But just wondering if you can provide some color on how you're thinking about that reacceleration in stack trends for the rest of the year. Certainly, you should benefit from less trip consolidation, as you talked about, as things start to normalize. But that also means there's likely more of a shift to food away from home from food at home. So just any help reconciling those 2 things would be appreciated.

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

Yes. And there are all things that we're looking at. I'll let Denise expand on this. It's all things that we look at going forward. But we've said fairly consistently that Q1, Q2 was always going to be a leap, not just for us, but for the whole industry, in terms of how that plays through. And on a 2-year stack basis, we're expecting a lot of our initiatives to gradually and just see an improvement in Q3, Q4 on a 2-year stack basis as we start to kind of normalize the comparisons.

And as you said, we didn't get as big an upside last year, so we shouldn't get as big -- we should be able to see our Q3, Q4, 2-year stack just improve naturally as part of the underlying business that we have. And as I said, we're very excited about the marketing activity that we've put in place, the test and learn that we've done that, that work will start to pay dividends for us in Q3, Q4.

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

Yes. And I think the only other point that I would add is don't forget the fact that we will continue to have new innovation coming into our stores, building off of all the category management work that we worked on through the fourth quarter last year. And it takes a little time to get that into our stores. And we will also have -- we already have one of our new DCs open as of the end of the first quarter, and we'll have a second DC opening now here in the second quarter, both of which are going to bring fresher, more local products into Florida, into Colorado, important core markets for us, where we really believe that that's going to resonate with customers as well. And so all these strategy points coming together are where we see the momentum coming from as we turn from the first half of the year, which certainly has its unusual overlaps, into the second half of the year where we can really have these things shine for our customers.

Operator

Our next question comes from the line of Chuck Cerankosky with Northcoast Research.

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

Good afternoon, everyone. Could you talk to us, Jack, about the sort of regional trends in sales without being overly specific as different states and even different counties have reopened in varying ways and what you're seeing in the stores, especially things we might not expect?

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

Well, let me -- California is clearly important to us. We saw in December a little bit of a boost in our California business as the close-down went down. And then in January, it went the other way. So if California has clearly seen, that's beginning to settle down.

As we look across, we're seeing more consistency across the country in the last few weeks than we had seen previously. I think as you just gradually people feeling more confident about getting out and moving around, I think the vaccination program. And again, I think our customers are more likely to get vaccinated than the average and more likely to be comfortable at coming out, we're seeing that kind of consistency. As we kind of talked about, our baskets holding quite well, and that would be true across the country, just to make -- we're not seeing the differences that we probably saw last year and certainly in Q4 that we're starting to see now. So I don't know if that helps, really, but I think we're seeing more consistency than differentiation over the course of the last few weeks.

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

Anything in the product mix that you would point out?

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

Yes. I think, as I said a little bit earlier, as restaurants reopen, you see a change in the meat business a little bit. That slows down a bit. Alcohol, which went absolutely crazy for all sorts of reasons last year, that's beginning to slow down a little bit relative to where we would have expected -- maybe would have expected it to have been.

But by and large, it's generally to do with restaurants. Finally, we're seeing some pretty interesting things happening in vitamins, although the cold and flu season went down in January. As we start to navigate through April and May, you're starting to see people, I think, migrating back to things that are very health-focused. And so there's a little bit of an interesting trends happening in that space to the positive for us.that we're intrigued by. And so if that kind of maybe vitamins would be the biggest -- I don't know if there's anything else, Denise, that we should be commenting on?

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

No. I think you hit the big ones.

Operator

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

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

First, I just wanted to follow up on the comment about traffic in March and April and great to hear that it turned positive. Just was curious if you could help us understand a little more context about what that looked like last year and what you were maybe comparing up against? And is that comment just about in-store traffic? Or is that total transactions? And then I have another follow-up.

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

Yes. And so let me put in first in context last year. So last year, if we all remember, really all of March and particularly early in March but continuing March into April, what we saw was a dramatic reduction in the number of times people were coming into the stores and very large baskets. So

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people coming in and buying whatever they could get, wherever they could get it as we all knew there were silly things like shortages of yeast or pepperoni or cheese that people would go and look for it wherever they could find it.

So last year, we definitely saw a notable downtick in traffic but a correspondingly big growth in basket. As we work through the year, our traffic trends got a little bit better, but they stayed negative through the year. And basket fell off a little, as we would expect, after that being stock-up but also going to stabilized Q3 into Q4.

When we turned into Q1, those same trends really existed in January and February, which were all pre-COVID last year, so that made a great deal of sense. I think we saw the same volatility that others would see in the early part of March, where this was lapping the height of things from last year. And that would be where we just fundamentally all were readjusting to our businesses. What we saw as we got to the very end of March and into April was the recovery of traffic. So on a 2-year stack, it's not a net positive yet, but it is headed in the right direction. But I think the most encouraging part to us is not only is that number headed in the right direction, but the basket really helped. And that tells us that things are resonating about what people are putting into their carts and what they've come to adopt in shopping at Sprouts. So hopefully, that's just a bit of color that helps.

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

Yes. That's really helpful. And just also kind of along the same lines, you talked about some customers, I guess, relaying to you that they have plans to come back to Sprouts post pandemic, and maybe you're starting to see that a little bit. But can you quantify what percent of your customer base you think that is and what maybe is embedded in your guidance with regards to that customer coming back? Do you expect that to be a certain percent of them coming back? Is that expected to just improve as we move through the quarters? And do you know who you lost them to in the meantime?

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

Yes. I think, in general, we do know who we lost them to. We lost them to folks that were just consolidating shop, which could have been whatever they have chose to consolidate to. So they could have consolidated to Kroger, to an Albertsons, to a regional conventional. Some even bid into a Target or that type of environment. They told us loud and clear, they just reduced the number of places that they were going. So anywhere they could get a full shop is where we would have seen them consolidate a bit.

In terms of the way we're planning, we haven't built the plan at the level of detail of this customer we lost, what percent of them do we think that we'll get back. I think what we're more reacting to is we do expect through the year that our customer counts will continue to improve and we believe a good portion of that from what the customer has told us. But the majority of the folks who told us they had slowed down or stopped coming to us through the pandemic who told us that they would return, we think that will be a good proportion of where we see those gains. And -- but we also have expectation that with the marketing campaigns and programs that we have out there that we'll be able to continue to bring new customers in as that kind of fear of COVID and fear of shopping starts to subside and the resonance of the messaging of Where Goodness Grows and what we stand for. We might be able to get a bit more reach out there to some folks who might not know about us as much today.

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

Certainly those new customers. I think we built a lot of stores through that year, and it wasn't the time for people to experiment with new stores and try new things out. So that's a big part of the marketing going forward. We think the stores that we did open over the course of the last year have got great opportunity to build once the pandemic kind of died down a little bit.

Operator

Our next question comes from the line of [Chris Jordan] with Goldman Sachs.

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Unidentified Analyst

Great quarter. I had something. A debt-free grocery store with a history of strong profitability in a world with 0% interest rates is a crime against capital structure theory in Modigliani-Miller. I'd like your perspective on your balance sheet. That's my only question. Good job. Good quarter.

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

Thank you. It's a good question. I'm going to hand it to Denise.

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

All right. So in general, we're incredibly pleased to have a very strong balance sheet at this point in time. And clearly, compared to prior history of the company, we currently have more cash on our balance sheet than we would plan -- than we would have had before or we would plan to have go forward. And we're going to be putting quite a bit of that cash on the balance sheet to use.

And when we think about building out new stores, the technology we've talked about, our second DC coming online, so we feel good about that. And then I think, as we announced last quarter, with our share repurchase authorization, you're going to see us investing in ourselves and buying back more of our stock go forward. But overall, I will take a flush with cash balance sheet for a period of time here, and we will work our way back into all of that being great investment for the company go forward.

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

And what I would say a little bit about what we might do with that, as we look at our new format stores, of which we've got a couple happening in July, there'll be elements of that, that we want to try and put into our existing store base. And we'll have to think through exactly the things that particularly I'm excited about, the innovation centers and how we can make that really relevant and really effective. So there's some things we can do with us going forward, and Denise and I often talk about such issues.

Operator

Our next question comes from the line of Edward Kelly with Wells Fargo.

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

Yes. Jack, I'd like to ask you, you've obviously made the argument that the company is running sort of like lower profit or lower-return promotions in the past. My question around this, though, is that the company wasn't really comping all that well for a number of years, though. And that doesn't really suggest that Sprouts was buying sales. It's probably more complicated than that. But what are we missing here if we're just sort of thinking about it more simplistically like that?

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

Well, you've kind of taken me back a little bit to the kind of where we were 1.5 years ago. I think my own view as to what was happening was as the company was chasing top line, it was actually deflating top line at the same time. So buying an awful lot of empty volume and an awful lot of empty customers, that not only were you -- were they attracting these, what we call the coupon-clippers and we've identified those people. Plenty of coupon-clippers were coming in. They were getting a deal, but everybody else was getting that deal and not responding in terms of any volume.

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So the combination of the kind of target customers that we've got at the moment, paying -- getting access to very low -- below profit, negative profitability items, whether it be commodity chicken or sweet corn or the things that they were chasing after. So not only was it kind of -- it was giving people something for nothing and not generating volume and attracting customers who aren't spending at anything and just losing money. So I think that's why the top line started to dissipate from that. You started to see it getting into very low numbers. So I think it was that downward file that grocers often get into, where they chase it. And actually, you deflate it. And I think that's what was happening. And we're trying to -- well, we have done, we've changed the kind of momentum of that so that we're chasing after customers who kind of value what we've got. And we will promote with those customers, and there will be promotions that are accretive to us rather than negative to us. And then we'll take it kind of going forward. I think that's the reason that, that happened.

And what you find is the business was becoming -- trying to become a conventional grocer by doing conventional grocery kind of things. And what we've tried to do is be really clear that we're a specialty grocer, that we sell things that other people don't sell. We've got a very big proportion of business in fresh produce. We've got a big proportion of business in bulk. We've got a big proportion of business in vitamins. And in many ways, the commercial strategy of the business was missing the differentiation and chasing after conventional. And that's what we're in the middle of changing. And as we said earlier, in the early innings of this, but we're very clear that where we were going was probably deflating our business and not attracting customers who are going to give you long-term profitability. Does that make sense, Ed?

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

Yes, yes. And just, I guess, a follow-up to that. So as it's -- you've heard a lot on this call, I guess, right? Like look, it's hard to imagine Sprouts getting the multiple that you probably think it deserves without this comp improving from here. How are you thinking about the time frame around when you would expect comps to reflect what you believe like the underlying fundamentals of this business are? And are we waiting for store growth to ramp up and any stores beginning to mature and then not building into the comp? I'm just kind of curious as to what the time frame is that you think it's acceptable for comps to get to a more reasonable level.

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

Well, we're focused on growth, not comp. That's the real kind of focus on our business. I think it's interesting. A lot of the grocery guys are hitting higher comps. If you look at their actual underlying growth of the business is significantly less than the comp number. We're exactly the opposite to that. So you are right. There will be some maturity in the new stores that will drive some comp sales going forward, but our focus is very much on how do we grow our business, which we've been pretty clear that we can grow our EBIT. We can grow our EBIT substantially into the -- I'm quoting certain numbers, but we've been pretty clear that our sales growth can be north of 10%, and our EBITDA growth will be north of that. If we can consistently deliver that month after month, quarter after quarter, that's the direction we're moving in. And this business will move from a $6.5 billion business to north of $8 billion business over the course of the next few years and a very substantial margin growth, so generating very significant EBITDA growth. That's the program we're on, Ed, and that's what we're driving.

Operator

Ladies and gentlemen, due to the interest of time, I would now like to turn the call back over to Jack for closing remarks.

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

Yes. Thanks very much, everybody. I appreciate the time, and I really appreciate your interest in our business, and I look forward to continuing the dialogue over the next few quarters. Take care, everyone. Thanks so much.

Operator

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

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