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SFM.OQ - Q2 2021 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to Sprouts Second 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 the conference over to your speaker today, Susannah Livingston, Vice President, Investor Relations and Treasury. Please go ahead.

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

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

The earnings release announcing our second 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 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. In addition, because our results for the second quarter of 2020 were significantly impacted by the COVID-19 pandemic, this presentation will also include certain comparisons to results in the second quarter of 2019.

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With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today. In early 2020, we embarked on a new strategy that led to a positive step change in our financial performance, which is strong and sustainable. While we have plenty of work ahead, I'm excited about the progress we have made and the continuation of our strong profitability this year. Due to the pandemic, results were down compared to last year.

Our year-to-date 2021 sales are up 9.5% and our profit is up 56% compared to the prepandemic same period in 2019. We have made great strides in executing against many of our strategic priorities. We have a differentiated model and a great team in our stores, which gives me great confidence for the future. The creation of innovation centers through dedicated merchandising displays, an increase of seasonal and local produce, the opening of 2 new fresh distribution centers and the opening of our first new format store in July, are among many changes that are driving our strategy forward. Plans are now in place to roll out our innovation centers to all our new stores and many of our existing stores in the back half of this year.

Each month, these displays will showcase new-to-market attribute-driven items like vegans, rolled oats, butter popcorn, plant-based Wicked foods, and brass roots, organic sacha inchi seeds. And thankfully, the country is in a place where we can start an active sampling program, which is a new endeavor for Sprouts and will prompt education trial and purchase. We're leaning into why customers loves produce. Our produce pricing remains ultra competitive with prices significantly lower than the marketplace.

We just went through a great cherry season, which showcased more than 5 different varieties from unique family-owned farms like the Orondo Ruby cherries and the Skylar Rae cherries with distinctively different flavor profiles than the common red cherries. We excel at great produce buying, and we're only getting better with our 2 new DCs added this year.

Our organic produce is up to 35% of department sales, which we believe is one of the highest penetration rates in the industry. Our organic produce prices are very competitive, and we are now focused on getting some of our organic produce prices in line with conventionally priced items, making it a clear differentiator for Sprouts.

On the supply side, our Aurora, Colorado DC is running strong, and the Florida DC just opened in June, getting us back to our farmers market heritage. We're now at more than 85% of our stores within 250 miles of our DCs.

At Sprouts, our sourcing practices, paired with our strong relationship with our local growers, are a part of how we bring the freshest produce to our customers all year long. With the addition of the Colorado DC, we have already noticed an uptick in produce sales in this region, as fresher produce and larger local selections are being recognized by our customers.

Specifically, our ripening rooms for bananas and avocados in Florida and Colorado have contributed to significant improvement in sales for these products and these regions. Produce is in peak summer season in Colorado, and our local buying has increased substantially and will gradually increase through the growing season, up to 20% of the department or a 300% increase versus our past assortment in previous years. And with the addition of our Florida DC, we will be able to provide an even larger range of affordable organics and locally grown items during the fall growing season in this region.

Creating this advantaged fresh supply chain has provided benefits this year, which will ramp over time as we cycle the regional growing seasons and expand our business. All in all, this leg of the strategy is in very good shape as we head into the back half of the year, and we begin to leverage the close proximity of our DCs to our stores.

Our 35,000 team members in our stores continue to do a great job. We've restructured our store leadership to reduce the (inaudible) of control. And in stores, we've restructured to ensure our team members can spend more of their time taking care of the customers.

As planned, we opened 1 store in the second quarter in Reno, Nevada. And continuing with our plan, we've opened 2 more in the third quarter to date and remodeled 1 of our California stores. Two of those stores were in the new format. These new formats will make it easier for our health-minded

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and food-centric customers to explore the market's unique and attribute-driven products. Enhancements include all new signage and decor, featuring Sprouts' new branding, and expanded frozen department offering easy, innovative meal solutions with more than 115 additional new items, including meat alternatives. And an expanded refrigerated section, highlighting the latest plant-based foods.

As a reminder, this new format will have a smaller footprint, but more selling space per square foot, similar to many of our original Southern California stores. The smaller side is very efficient and keeps produce at the heart of the store while maintaining our familiar open layout and treasure hunt shopping experience. They also cost 20% less to build, and we expect to have similar sales to our boxes that we have to date, resulted in expected higher returns. Our plan is to open 3 more of these new format stores across the country this year.

With all this said, sales were slower than we expected in the second quarter. While April experienced strong results, both top and bottom line, we were disappointed with May and June. Customers are enjoying travel and dining out again. And against this backdrop, marketing did not drive as much traffic as we would have expected. To be clear, our brand campaign has reached more target customers, increased awareness and purchase intent, which is a very important first step, but more will be needed. We're making necessary changes going forward as we continue to update our marketing mix with a test-and-learn approach. The intent is to convert awareness into increased traffic. Given the strength of our basket, we only need a modest increase in customers to fulfill our long-term strategic goals.

Let me share a bit of what we have underway. In the third quarter, we're focused on refining our marketing to drive traffic with targeted call-to-action offers, unique partnerships and continuing to push brand awareness. We're connecting with those customers who know us with more touch points to foster more loyalty. We've mailed goodness guides, which highlight our seasonal produce offerings as well as new offerings like our 100% grass-fed Angus steaks and promote those find-a-new favorite items, many of which are exclusive to Sprouts. We continue to offer weekly specials online through a digital ad, supported by extensive media, both paid and owned. And we're expanding our full-size digital coupon freebies program for Sprouts account holders to encourage trial of new products, drive traffic and grow our database.

We're building an innovation network by cultivating partnerships with up and coming vendors in the food industry. For example, our GloSlim SpiceFruit drove immediate customer interest and traffic to the vitamin department after being featured on the front cover of Women's World. And we're collaborating with many other vendor teams, becoming the destination for their products like DEFY Water, Kettle & Fire bone broth, and [factory's] Pipcorn.

Before I hand it off to Denise, I want to acknowledge the credible work with teams at our stores, DCs and in the support office continue to do week after week as we expand our business in markets across the country. Our strategic initiatives are laying the foundation to solidify our position as a highly profitable specialty grocer with a strong unit growth story, making me confident we are well on our way to delivering the growth and returns presented in our 5-year strategy.

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

Good afternoon, everyone. For the second quarter, we generated adjusted diluted earnings per share of $0.52 compared to $0.59 in 2020. Compared to the second quarter of 2019, earnings per share was up 73% as we continue to maintain our improved margin structure and make decisions rooted in positioning Sprouts for long-term profitable health.

For the second quarter, net sales decreased 7% to $1.5 billion, and comparable store sales were down 10% compared to the same period last year. On a 2-year basis, our net sales were up 7% compared to the second quarter 2019, and our 2-year comp stack was nearly flat at down 0.6%.

As a reminder, to account for the 53rd week in our fiscal 2020, we shifted each week back 1 week, thereby ignoring the first week of fiscal 2020 to better align holidays for comparison purposes. Because of this, the 2-year stack will not be the simple addition of the 2 periods. More information can be found at investor.sprouts.com under Additional Reports, if needed.

April sales started off strong, in line with our expectations and posting positive traffic. May and June experienced more challenges. As Jack mentioned, we believe the reopening of restaurants, travel and people going back to the office contributed to the slowdown. Having said this, our basket remains strong, trending down only modestly since the first quarter of 2021 primarily due to lower e-commerce penetration. Our deli sales were

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strong this quarter partially driven by lunch time trends, which nearly doubled and speaks to customers being back at work as well as an increase in prepared meal solutions like One Pan Meals. Vitamins experienced a marked improvement from the first quarter as our customers got back to basics with added proteins and sports nutrition.

The benefit and ease of online shopping has remained relevant for a portion of our customers. For the quarter, e-commerce was 10.1% of sales, settling in the 9.5% range towards the end of the quarter. Compared to the second quarter of 2019, e-commerce sales have increased more than 350%. We've been absorbing the additional costs associated with these services for over a year now. Importantly, for orders placed through the Instacart website, we're seeing about 50% of the transactions are for customers who have opted in to share their data with us. When combined with our own shop.sprouts.com, we are collecting meaningful customer data on around 2/3 of those who shop online. We're also working more closely with Instacart on analytics to support both our e-commerce and brick-and-mortar businesses.

We believe the higher use of e-commerce for grocery isn't the only customer habit that has changed during the pandemic. To make sure we're driving business decisions on recent trends, we're currently performing new safe survey work to evaluate customers' habits in this post-COVID environment.

For the second quarter, gross profit was $550 million, and our gross margin was 36.1%, a decrease of 115 basis points versus the second quarter of 2020, in line with our expectations. This decrease was predominantly related to lapping opportunistic produce buys and exceptionally low shrink from elevated demand last year. Our efficient promotions, attractive everyday pricing and differentiated assortment continue to result in superior margins, which are up 330 basis points compared to the second quarter of 2019.

SG&A costs decreased $52 million to $436 million or 28.7% of sales, leveraging 108 basis points compared to the same period last year. The majority of this leverage was attributed to lower COVID pandemic response costs, mainly incentive compensation as well as lower e-commerce expense. This was partially offset by sales deleverage. Compared to the same period in 2019, SG&A increased 14%.

For the quarter, our adjusted earnings before interest and taxes were $84 million compared to $96 million in 2020. Compared to the second quarter of 2019, adjusted EBIT increased 63%, continuing with the positive step change in financial performance. Our interest expense was $3 million, and our effective tax rate was 24%. Even with some sales deleverage, we realized an adjusted EBIT margin of 5.5%, trending well ahead of our 3.6% margin in the second quarter of 2019.

We continue to generate strong cash flow from operations, $177 million year-to-date to fund future expansion and sales initiatives. In the quarter, we invested $27 million in capital expenditures, net of landlord reimbursement, primarily for new stores. Additionally, we repurchased approximately $87 million in stock by the end of the second quarter. We ended the quarter with $250 million outstanding on our revolver, $39 million of outstanding letters of credit, $221 million in cash and cash equivalents, and $213 million available under our current $300 million share repurchase authorization.

Subsequent to the end of the quarter, we repurchased an additional $25 million in stock for a year-to-date total of $112 million. 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.

Now let me provide an update on our 2021 outlook. As a reminder, I'm giving these comparisons on a 52-to-52-week basis, as fiscal 2020 was a 53rd week year. The COVID backdrop is resulting in an ongoing flux in customer spending habits and continued consumer hesitation for doing multiple shops. While our basket has remained healthy this year, we haven't realized the growth in transactions that we originally planned. Because of this, we are reducing our top line expectations. We expect net sales to be down low single digits versus 2020 with comparable store sales down 5% to 7%.

Our 20 new store openings for 2021, while ink and signed may not be completed by year-end due to difficulties in securing certain equipment from third parties because of supply chain delays that have been complicated by the pandemic. At this time, we have about 7 store openings that may be delayed to 2022, although we continue to explore options to open these stores by the end of the year.

The good news is that our real estate pipeline remains strong, and we continue to work towards our 10% unit growth goal in 2022. Similar to 2021, we expect our 2022 new store openings to be weighted more to the back half of the year. With the potential store delays, we now expect 2021

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capital expenditures, net of landlord reimbursement, to decrease to the range of $110 million to $125 million. We continue to expect our corporate tax rate to be approximately 25%. Our scenario we're planning, which contemplated potential outsized sales volatility has served us well, resulting in our EBIT range remaining in line with our prior guidance of $305 million to $325 million.

Due largely to shares repurchased in the second quarter, we are increasing our adjusted diluted earnings per share to be in the range of $1.90 to $2.02. We continue to expect to maintain a majority of the gross margin rate improvement we realized in 2020 with the next few quarters being slightly pressured as we cycle some COVID benefits we don't expect to repeat.

In closing, we continue to remain confident in the strategic changes we began last year, which has structurally changed our financial algorithm for the long term.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Krisztina Katai with Deutsche Bank.

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

So I just wanted to start with the top line. I know you guys have a very different sales mix and a customer profile that you're targeting, but your 2 year just turned negative for the first time, but industry data remains strong. So I'm just curious if you could just talk about your level of confidence in the strategy that you are indeed targeting the right customers in the right way. And then I also wanted to get your thoughts. I believe, Jack, you talked about fine-tuning your customer communication. So if you could just talk about what it is that you're trying to do to really drive customer traffic.

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

Yes, Kriztine, where we're at the moment is we're feeling -- well, we're feeling very strong about the strategy in terms of the way it's been flowing through in terms of what we've been -- what we've been doing and what we've been making work. The encouraging thing a little bit is that our basket, which we expected to decline a little bit more, hasn't declined, but our traffic hasn't grown. But make it -- be really clear. Our traffic is kind of stable. It's -- we -- through the pandemic, and there's a lot of noise in the pandemic. If you take it back to 2019 and take it today to 2021 on the Q2, our traffic went down through the pandemic as you'd expect. Our traffic went down as you'd expect because of the change in our promotional position and how we kind of went to market. We expected to lose some of those. If we'd said prepandemic, we expected that.

Since the last couple of quarters, we're seeing a pretty static customer base. So it's not that we're losing customers, but we're not gaining them as fast as we would like them to do. And that leads on to your second kind of point, which is what are we doing to stimulate that demand and stimulate that traffic. And we're doing a variety of probably more call-to-action promotions as opposed to the kind of generic brand building that we had -- we did. We're very pleased with it. It's giving us good awareness scores, which is always a problem. It has always been a problem for this business. And it's also giving us good intent to purchase scores. But what it's not doing is translating itself into more people coming in, which we would have expected to have happened by now.

And Kriztine, we don't need that many more customers for the equation of this to work. And the good thing from my point of view as we look at different tactics and different call to actions to drive that traffic, we've got -- because of the financial strength of our model now, we've got a lot of, if you like, arrows in our quiver, that are able to -- we can deploy them. And we're doing a number of things, testing a number of things in a number of different places, both regionally and different category approaches, and that's what we're encouraged about going forward. We've got room to

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play and we've got some options that we're working on that I'm feeling pretty confident that the base that we've built in terms of the merchandising changes we've made, the supply chain changes that we've made, the real estate changes that we've made going forward, puts us in a strong position to position ourselves with the target customers.

And as we've said often on these calls, there's enough of those customers. We don't need many of them for this thing to look very dramatically in a really dramatic way. The returns that we can get if we can get a few more customers in this, really are exceptional. But thanks for the question.

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

And just if I could just squeeze in a quick follow-up. Maybe if you could share what your performance is in recent weeks as we're looking at the third quarter. Your guidance assumes a reacceleration on the 2-year stack. So how should we think about the cadence between the third and the fourth quarter there? And we're starting to see some companies delaying the return back to office, some of them are into 2022, which, in theory, could help you guys. So I wonder if you could just kind of talk about some of your thoughts there.

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

Yes. We can't talk specifically about where we're going. You can see -- you can have a look back and see the comparisons change a little bit. So I guess, some of the comparison triggers make this a slightly different number going forward relative to where we've been in Q2. But we can't talk specifically about where we're at in that kind of dynamic. I think with regard to return to office, what we saw as people go back to office, we certainly got a benefit in our deli business from that in terms of people being around and going in and buying those kind of things, as Denise alluded to in some of the remarks.

What's happened, it's certainly an uncertain time for us all. In terms of our own business, what are we going to do with the office? We had everybody coming back in September. But now we're kind of -- we think that's what we're going to do. And now I think that's the way the market is going to be. If it's delayed, then I think there will be a dynamic change in terms of how the customer reverts back to some of the behaviors that happened in the pandemic or -- we're trying our best to not talk about the pandemic going forward. We're trying to talk about now the COVID is over, and we're going to get ourselves into Q3, Q4 in terms of really getting back to driving the traffic within the strategy that we've outlined.

So I don't know what's going to happen with regard to the offices and whether people are going to go back or not. If the offices close down again, then it will make a difference in terms of how traffic and basket plays into our stores.

Operator

Our next question comes from Scott Mushkin with R5 Capital.

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

So I guess the first one, obviously, everyone's going to poke at the sales issue because it's the elf in the room. I wanted to talk about the differences, if there are differences, where you have more density, Jack. Like Southern California and Phoenix, where the brand is really well known. Like I think, you have obviously a popular following and compare that to less dense areas. Is there a difference?

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

In absolute terms, no, and in relative terms, no. There's not a huge difference across the different marketplace. But in absolute terms where you're starting from a different -- in different marketplaces, as you alluded to, Scott, Southern California, Denver, some of the other markets where we're more established in Los Angeles and beyond. We -- we're seeing -- as I said, the encouraging thing for us is that the basket is holding up in those places or the basket is not going down by as much as we would have expected it to do. And the traffic dynamic that's happened in those areas

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isn't really a surprise to us that it went down, because in 2019, we were pretty clear pre -- in Q2 2019, but the traffic was there. A lot of that traffic was coming in response to the weekly promotional cadence that we had, very aggressive pricing on so low margin. And changing that we did see a reduction in traffic that then gets all confused by the noise of COVID, which probably take it down further.

We would have expected our traffic to have bounced back a bit harder in those places. And that's back to what is it we need to do in terms of building the clarity of our messaging and then the call to action, the immediacy of the call to action that we need, and that's the things we're testing out at the moment. But to the crux of your question, we're not seeing a significant difference across the different marketplaces.

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

And I'd just add the point of what we do know is we just started a different water level. So some of our California stores are just much higher volume starting stores than perhaps our Florida stores. But to Jack's point, the relative change is not materially different across the regions.

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

And as a follow-up question, when you say call to action, Jack, is that just getting a little bit more promotional? Or how do we think about it? And any thoughts on how this Tustin store is doing so far? I know it's only been a month or so, but love to understand how the new formats even though it is remodel performing.

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

Yes. Well, Tustin was a little bit of a remodel, Scott. As you know, the new 1 that we've opened in Phoenix, which we're very excited about, we opened 10 days ago or something like that. So it's early days, but so -- and we're very encouraged by the customer reaction to the changes that we made in Tustin. We got a lot of positivity. The encouraging thing for me with regard to that is the way customers are saying, well, I thought you are now building smaller stores, but it feels bigger. And that's certainly the feedback from the Phoenix store, which we built at 23,000 square feet and the people that -- people in Phoenix know our business well, and they actually think the store is bigger. So that's encouraging in terms of going that -- it's too early to say in terms of the absolute level of the numbers.

Call to action. The call to action kind of -- will be more of -- less about very direct product and priced high-low kind of drivers. It will be much more about, if you like, dragging people to the offer and the proposition that we have, whether it be plant-based, whether it be our new meat assortment in terms of our whole Angus and grass-fed beef assortment, whether it will be towards our keto business. It will be much more about how do you tell the story and give a value against our vitamins and HABA business give a value to our bulk now as we relaunch our bulk.

It will be more about category and very -- and aggressive in some ways. As I said, we've got some resources to do that. So it will be aggressive in that way. What it won't be is a return to 10 per dollar corn.

Operator

Our next question comes from Ken Goldman with JPMorgan.

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

It's Tom Palmer on for Ken. I just wanted to follow-up on the promotional discussion. Do you think if you chose to, you could drive traffic with heavier promotions? Just in the current environment, are promotions as effective than they've been in more normal period? Just trying to understand how you think about that potential lever as you reach out to customers.

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

Yes. I think it's a good question about whether the dynamics have changed. I think there's certainly -- I think the holidays -- our competitor, if that's how we'd want to call them, the mainline groceries are certainly going back to more aggressive promotions around the holidays on products that we don't sell. So I think there may be some evidence that, that can drive some traffic in the post-COVID world or the kind of ending of the COVID world. Our -- could we drive traffic by going back to aggressive pricing? Probably. Would it be the wrong people coming into the stores? Probably. Would it help us? Probably not.

So, Ken (sic) [Tom], our whole business is about driving the traffic of the target customer base and winning dollars and market share from that target customer base. And that's the call to action that we're putting in place. The last thing we want to do is drive in very low profitable customers who just come in for the deals, which is where we came in a couple of years ago. And that's why the comparison to 2019 Q2 and the Q2 in 2021 works for me in terms of understanding our business.

We've reshaped the whole proposition of the business, and we've reshaped it to target against specific customers who appreciate the differentiation that we have, so that we're not going head-to-head with anybody on pricing or promotions or -- and we don't actually have to win a trip from anyone. We just need to win some dollars to drive the transactions. So I think to answer your question, we probably could get traffic back in, in terms of the wrong traffic, but it doesn't feel like that would be the right place because we'd go back to making a lot less money as well.

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

Okay. Understood. And then just on the store delays. So if some of the 2021 openings get pushed to 2022, you indicated that 2022 could be back-end loaded. Could we expect some of these stores to then just get pushed into 2023 given the bandwidth constraints? Or if those stores get pushed, should we think about 2022 being 10% unit growth plus, whichever portion of the 7 stores get delayed?

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

Yes. Great question. And we usually keep the 2 pieces separate. So I'd say, we continue to be optimistic about our core 2022 pipeline in terms of deals that we have in the works and getting to that 10% new store growth that we wanted. Any impact that happens with up -- to these 7 stores from 2021 is a separate outcome than what would be in 2022. So if some of them push, that would make the 2022 number bigger, not really be a replacement and then a belief that 2022 would push out.

Just for folks to understand, the delay in the stores that we have is really tied to some of the refrigeration equipment and some of the inputs that go into how those get installed into stores, working hard to find alternatives to just some supply chain constraints in some of that product inputs being able to come through. So we don't expect that this is going to be a long-term sustainable issue that we have about our own capacity to build the stores. It is just a near-term supply chain constraint.

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

And some of these things we could have done differently will be known. So we've not given up on those 7 stores yet. So we'll see where that plays out over the next few weeks.

Operator

Our next question comes from Robbie Ohmes with Bank of America.

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Kendall Belinda Toscano - *BofA Securities, Research Division - Research Analyst*

This is Kendall Toscano on for Robby. I wanted to see if you guys could give us any color on how SG&A performed during the quarter versus maybe what you were expecting. I guess, as a percent of sales, were you expecting it to be down as much as it was? And should we still be thinking about a flat rate of sales for the year?

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

Yes. So in reverse order there, we are still expecting to have a flattish rate of sales for SG&A for the year as we have expected throughout the year. The quarter did come in as we expected. The 2 main drivers of the help in the quarter were the lapping of number of the COVID-related compensation and incentive items that were in place last year that we knew would come away and come out of the model this year. And then secondarily, as we were expecting, we saw a little bit of a trickle down in e-commerce penetration, which then reduced some of the e-commerce fees in the model as well. So very much in line with expectations and do expect the full year to be flattish as we look to close out 2021.

Kendall Belinda Toscano - *BofA Securities, Research Division - Research Analyst*

Got it. That's helpful. And then just kind of as a follow-up on the 2-year same-store sales trends. I apologize if I missed this, but should we still be thinking about an improvement on the 2-year stack each quarter moving past 2Q?

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

Yes. I would say the way we really are thinking about it right now is what we gave in the minus 5 to minus 7 comp. We're going to come up on an easier comparison to last year as we work through Q3 and Q4. So that's really what's factored into the baseline, gets us to the minus 5 to minus 7 for the year.

Operator

Our next question comes from Greg Badishkanian with Wolfe Research.

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

This is Spencer Hanus on for Greg. Can you just comment on partial basket shopping? And when do you think that's going to get back to pre-COVID levels? And you guys aren't the only retailers that experienced some loss of shoppers as people have consolidated trips. Walmart comes to mind as another big 1 that's facing some challenges there. What do you think is the strategy the industry uses to sort of get those shoppers back? Is it price-driven? Is it more focused on advertising? How are you thinking about that? And then in terms of your value scores with your core customers, how has that sort of changed over the last few quarters?

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

Yes. That's a good -- both good questions. In terms of -- I think ultimately, what happens will be driven by COVID and the customer behavior. That customer behavior, I'm not sure retailers will be able to influence that. Because really over the pandemic, it's not really been the retailer's behavior that's influenced a lot of what's happened. It's been the customer behavior and how they view the context in which everything is coming at. I mean, it's clearly we had expected. Even a few weeks ago, we had expected to be in a different place today relative to where we were then. Now who knows how people are going to play out with it.

Now what will the retailer do to try and attract traffic within that environment? I think probably it will be more about trying to invest if they need to, invest in some kind of promotional technique to try and get people by probably using loyalty and data information more effectively than we've

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had in a moment. That's certainly something we're thinking about how best we can communicate directly with our target customers and really kind of give them a rationale to come back and probably get you some call to action, as I just kind of outlined and talked about.

Now the second part of the question, I kind of lost my...

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

Just how customers looking at value.

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

How the customer is looking at value? We're doing a lot of research on this. I think Denise alluded to in her remarks. We're doing a ton of research to understand our target customer. And what their perspective is the ones that we're targeting are pretty much looking at it as it's the same as it's always been at Sprouts. It's kind of good value on produce. I think people recognize that. I think they recognize the differentiation and they recognize the value behind it. We're not seeing significant -- we're not seeing any score changes in terms of value amongst our target customers. And that's something we're looking at because that's important to us. And I think that's why we're getting pretty static traffic at the moment.

The question is, how do we translate -- how do we get to translate this awareness that we've got and this growing awareness into transactions. And we think, as COVID kind of dilutes and becomes less important, we think that's going to help us as we get these calls to action into the marketplace with our target customers.

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

Yes. That's really helpful color. And then I just wanted to ask on inflation. What was that running in the second quarter? And how are you thinking about sort of passing that through sort of over the next -- in the back half and then into 2022? What -- do you think there's acceleration? Does it remain pretty sticky? Or is this more of a transitory inflationary environment that we're in today?

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

Well, we're being told that it's a transitory inflation environment, but let's wait and see. I think we'll manage it as it goes. Produce has been pretty up and down, but pretty flat in terms of -- we're not seeing huge problems passing on our -- the pricing changes in produce. The protein side of things, salmon and beef, and we have seen significant cost price increases, and we probably haven't been able to pass on quite as much as we'd like to, but we do see it. Certainly, we're planning it on being transitory and that this thing will go back to normal in due course.

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

And it really was in the fresh side of the business. We've really not seen anything material on the nonperishable side of the business to date.

Operator

Our next question comes from Mark Carden with UBS.

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

So last quarter, you noted that you were starting to see some customers trickle back in that may have been consolidating their trips to the Krogers and the Albertsons of the world during peak COVID. It sounds like some of this has stagnated a bit with a Delta variant. Does it become harder to

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get these customers back as they become more used to shopping for natural organic at the competitors? Maybe get immersed in their loyalty programs? And does it change your strategy at all for getting them back?

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

Yes. See, I don't think we've lost any of those customers, who are interested in natural and organic and interested in our proposition. And the data would suggest that our traffic stayed pretty flat with that type of target customer. The customers that we lost, notwithstanding the consolidation part, the customers that we lost were what we call the coupon clippers. The people that weren't particularly dynamically interested in our proposition, but they were interested in very low pricing on the fresh foods that we put in front of customers, whether it be chicken fillets or the corn or the tomatoes or whatever it might have been that we were advertising aggressively.

So the challenge for us going forward is not so much can we get them back from Krogers. It's -- can we get the message out and the call to action with those customers who are -- have an affinity to who we are, but we haven't got them in the store. Now if it's simply COVID has done that, I think that will happen automatically. I think that will happen automatically. If it's not COVID that's done it, I don't perceive that the challenge -- because the proposition, if you go -- if you've gone to Kroger, I'm so -- I said Kroger, but anybody in terms of the context of consolidating your shop.

And you've gone in and you said, oh, they've got some natural organic thing. I promise you the scale of the differentiation between what we sell and -- first of all, the pricing on produce. The differentiation from vitamins and HABA, the bulk assortment that we've got, the attribute-based products, whether it be keto, paleo is so different. Our frozen food business, 90% of what we sell in frozen foods is different to what I can walk around any supermarket. So it's differentiation. You cannot access it.

And as people -- as the people who've not shopping with us because of COVID, they'll come back on the basis of the differentiation that we've got. And we've got to give them a call to action to do that. And I'm very confident that we've not got that underlying challenge that people have gone to the mainline supermarkets and thought I can get everything I need, I would have got at Sprouts. It doesn't look like that in the data that we've kind of analyzed.

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

Got it. That's really helpful. And then on your digital customers, what's the breakdown then between delivery and curbside? Is it still skewing really primarily towards delivery? Any major differences in shopping habits between the 2? What are you seeing in spend per customer? Curious what you see on that front.

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

Yes. Overall, it still skews very heavily towards delivery. We just have a nature of a different product that comes in. So people aren't coming to us for curbside for the convenience of not carrying out 24 packs of water and huge packs of toilet paper. So it seems to be delivery really does resonate better with our customers. And we continue to have a nice portion of our business come to our own website versus through the Instacart Marketplace. And so we're pleased with that as well as that adoption continues.

In terms of overall difference of the customer, the e-commerce basket remains significantly higher than an in-store basket, which makes a lot of sense. When people are paying for that delivery process, they definitely want to take advantage of it. And so that basket is almost double, what an in-store basket would be. So very healthy business there. And overall, we've really seen e-commerce stay pretty sticky. So as we talked about on the call, 10% for the quarter, kind of only trending down to about 9.5% by the end of the quarter. Now we'll watch the volatility that might come with the Delta variant over the coming weeks and see if we see any change in trends. But it seems to be well embedded into the shopping habits of our customers right now.

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Operator

Our next question comes from Rupesh Parikh with Oppenheimer.

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

This is actually Erica Eiler on for Rupesh. So I wanted to switch back to your new unit growth here. Clearly, the team is very focused on opening new stores. But on the flip side of that, comps clearly remain challenged. So can you talk a little bit about why you're still being fairly aggressive on the new store front when the core business remains challenged? At what point do you say, hey, let's put on the brakes, maybe with our new store openings and focus on maybe a little bit more on driving comps and turning around that core business?

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

Well, I think we've been pretty clear about why we're in that place strategy-wise. What we had as a business, we've lost some traffic over the course of those 2 years on the back of the change in strategy, notwithstanding COVID. We've lost some traffic on the back of our promotional strategy. And that's why you look at 2019 and you take it forward to 2021, you can see that. And we've identified the target customer base that we need, and it's a pretty small number, and we've been pretty modest in our comp expectations going forward. We don't need crazy comps for the economics of this thing to work, as you can see from the earnings that we're delivering.

So if you can deliver superior returns on a relatively modest comp base, then the opportunity for us to grow comes with building a lot of stores in places where we don't exist. And there's so many of those, and we're trying to make sure that our distribution center will support that program of growth.

And the opportunity for us is, and we've identified this as part of the new format that we've opened a couple of them in the last few weeks. We can build the stores much cheaper. We can get them in front of customers in a smaller footprint. And we can drive pretty significant returns on that. When we look at -- when I go through the pipeline of what we've got for '22, 23, all kind of smaller stores relative to where we've been. And the returns that we can get on, relatively modest top line, gives us this growth potential that I think is pretty unique.

So I'm not sure that going back to trying to chase the wrong customers to get comp in our existing store base and abandoning the program of new stores would generate the kind of returns or the kind of cash returns that we can get going forward. And it's based on the premise of a couple of things. One is the customer is more interested in healthy options and healthy eating and focused diet than they've been. And they will be more interested in that going forward, than they will be less interested in that. We've got a unique proposition that nobody else can match, can -- would even want to do because we're narrowing what we do. And that narrowness allows us to target and allows us to build stores smaller in the right places.

And the numbers we're looking at, and I think the model's kind of demonstrating that over the last few quarters even through the kind of strange world we've been in, it gives us a lot of confidence that there is returns in a modest comp in our existing store base and a real opportunity for us to build 10% new stores every year and deliver significant returns.

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

Okay. No, I appreciate all that color. And then just on -- clearly, a lot of pressure points out there on the cost side. Can you maybe talk about some of the cost pressures you're seeing in your business right now, labor, transportation? And how you're thinking about the levers you have to pull to manage through them?

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

Yes. I think it's -- first of all, let's talk about the labor in stores. I think one of the things I've said in previous calls here is we're relatively a mature in our use of labor in the store. So there's things we are doing and have done that will mitigate some of the labor pressures. We start from a higher base than most anyway in terms of wages. So we're in a good place. It's not going to go up quite as much. I don't think as some others. We've introduced self-checkouts in a lot of our stores and are rolling that out fast. We didn't have any of that. So that's significant given the labor hours associated with that.

Our replenishment in terms of getting product from the back door to the shelf, a lot of systems in place to reduce the costs, the hours that we need to run our stores. So filling the shelves and taking the money through the register, we're relatively inefficient in the hours that we use. So there's opportunities for us to mitigate some of the pressures that are coming on labor on that basis.

And with regard to transportation, I'm really pleased that we built the distribution center in Colorado. So that we didn't have to drive from Arizona to Denver with the product. I'm really pleased we built a distribution center in Orlando, so that the product is driving from Orlando to Naples rather than Atlanta to Naples. So our transportation pressures are clearly real. We've actually mitigated them by build -- bringing -- and we said all along that less miles would save us some -- some really save us some cost. So we've kind of mitigated that.

But those are real pressures, and we think we're mitigating that pretty well. I don't know, Denise, you want to add to that?

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

No, I think you said it well, Jack. And I think for all those pressures coming forward, you can still see the profit that we're delivering through the company. So I think the realization that we do have, the cost saves to offset some of those pressures is evident in the results.

Operator

Our next question comes from 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 on gross margin. So far this year, it looks like you've been able to hold on to much of the increases you saw in 2020 versus 2019, which is in line with what you've guided to. But in the second half, it looks like your guidance implies much less of an improvement on a 2-year basis. So just wondering, outside of losing some COVID benefits, wondering if there's anything unique to the second half in terms of pressure that you may be expecting? Any color there would be helpful.

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

Yes. I would reinforce that we do believe that we will hold the vast majority of the gross margin gains that we've had over the 2-year cycle. The one thing that you might need to think about on a 2-year basis is that remember some of the improvements in margin actually started in the fourth quarter of 2019. So Jack joined us just before that at the beginning of the third quarter and started rolling some of the changes that we have today. And the fourth quarter was the first quarter where you would see some of the pullback of the very inefficient promotions. So that's why you will just see a little bit less of a full 2-year stat gain in the fourth quarter than you would see the balance of the year, only because we actually captured it a quarter earlier, if that makes sense.

Operator

And our next question comes from Chuck Cerankosky with Northcoast Research.

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

First question, if we're taking a look at the customers who might have reduced their visits to Sprouts, do you see any demographic reason, income reasons, that they might be the same customers who are dining out more?

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

I don't think I really know the answer to that, if I'm honest, Chuck. But clearly, that's a possibility. I think the way we look at what's happened to our -- there's been 2 things, the consolidation from COVID. And then there's been the reduction from less -- I'm talking 2 years, the 2-year stack in terms of traffic. There's been those two things, consolidation plus less stimulus in terms of very aggressive promotions.

With regard to restaurants, I think we saw a little bit of a peak at certain times up and down in this. But there's some behaviors that the customers have stayed -- kept going, which is I think why the basket's kind of held up when they do come in, whether it be a little bit of baking and a little bit of cooking, a little bit of meals. We're seeing a strength in our deli business, which would suggest the opposite to the question, but I don't know that I've really got the answer, Denise, to that.

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

Yes. And the one thing that I would consider is knowing that we have seen some strength in April, and that was the beginning of the reopening. But then May and June, I think we would all say whether we experienced it personally or in the public press, truly restaurants becoming busy again. Travel ticking up quite a bit. I have to believe that that's relevant for our customer base. More or less than someone else's customer base, I don't know. But it feels as though it was real that people were making choices to get out of their homes and to take advantage of what felt like the COVID glory days, for lack of a better way to put it, before the Delta variant really ramped up.

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

Okay. And when you're talking about call to action or promotions, could you talk -- tell us philosophically how that differs from attracting a new customer or a lapsed customer into your stores versus getting an existing customer to spend a little bit more and increase their basket size?

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

Yes. I think there are definitely 2 types of promotions that we're working on. In terms of driving the basket in the store when the customer comes in, there's some very specific activity that we're putting in place, a combination of bringing very exciting kind of new varieties of innovation centers where we've got products that people haven't seen before, and that drives it through. And very -- and probably more assertive displays of our produce business, more assertive displays of local produce, which we just kicked off in Colorado right now, which I'm excited about.

So local, seasonal innovation centers, there's a number of things that we're doing to drive traffic, to drive basket with the existing customer base. The second -- the other side of this equation is how do we drive the traffic to the store. And that tends to be more holistic promotions that we'd cover across. If you think what -- we've got to communicate, we've got good everyday prices. We've got great produce prices. We've got unique promotions, and we've got specific traffic-driving events. And that's what we're going through at the moment in terms of a number of call to actions.

For example, we ran 25% of all vitamins and HABA promotions, communicated it very effectively to the direct customer. That's the kind of thing that can drive some traffic and drive some specifics. So we're going to be running at 25% of both promotion, which, again, other people aren't going to run about after, and that allows us to kind of communicate the differentiation of our business. Organic produce, we can use that very effectively. Our organic produce mix is up to 35% of our sales. I don't know anyone that's selling 35% of the produce business that's organic. We're

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driving those kind of messages in our kind of digital way as opposed to using some of the techniques of being -- some mass media that we haven't used in the past. We're on TV, trying to do some of those things in some targeted markets.

So it's both sides of the equation. And I'm actually really pleased the way stores are getting behind the basket driving work because they can do a lot to help that, and I'm pleased with the restructure, the way the stores are getting behind it. We're seeing some progress on that. And then we're excited about the work that we're doing in terms of traffic building on the -- on those calls to action.

Operator

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

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

First, just wanted to be clear, and I apologize if I missed this, but just want to make sure we understand exactly what is coming in better on the margin front for you to kind of maintain your EPS range despite the lower comp outlook, just want to be clear on that.

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

Yes. When we planned to the beginning of the year, we had different levers that we would pull. You can look and say, which projects and how fast might they move, how fast can we move on shrink, where can we drive efficiencies and labor in our stores, and how quickly can we adjust to those types of activities. So what we're really doing is we're really pulling those levers that were available to us. We're not stopping progress on anything that is core to the strategy. But what we're really doing is being prudent throughout the P&L in terms of maintaining the gross margin gains from last year in the way that we wanted to do. Managing distribution costs and taking advantage of the fact that we have the 2 new DCs and taking transportation costs off the road. And then really working on our in-store productivity initiatives to be able to realize the savings that we need to keep the P&L strong.

Operator

Thank you. And this concludes the question-and-answer session. I would now like to turn the call back over to Jack Sinclair for closing remarks.

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

Yes. Thanks, everybody, for taking the time to listen. We're excited about our business, and we really appreciate you taking the time to -- spend some time listening to us today. So take care, everybody. I appreciate your time.

Operator

This concludes today's conference call. Thank you for participating. You may now disconnect.

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