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EDITED TRANSCRIPT

SFM.OQ - Q3 2021 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Good day, and thank you for standing by. Welcome to the Sprouts Farmer Market Third 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 third quarter 2021 earnings call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Chief Financial Officer, are with me today.

The earnings release announcing our third 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 non-GAAP measures to the GAAP figures, please see the tables in our earnings release. In addition, because our results for the third quarter of 2020 were impacted by the COVID-19 pandemic, this presentation will also include certain comparisons to results in the third quarter of 2019. As a reminder, to account for the 53rd week in fiscal 2020, we shifted

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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 comp will not be the simple addition of 2 periods. For more information, it can be found at investors.sprouts.com under Additional Reports as needed.

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. I'd like to start today by first welcoming Chip as our new Chief Financial Officer. Chip recently made the decision to resign from our Board of Directors after 9 years and join us full time. I'm excited to have him as a partner and a key member of our leadership team.

During today's call, I'll start with a few highlights. Chip will then provide a review of our financial results and outlook, and then I will return to provide details relating to our third quarter activities and updates on key elements of our strategy.

We have the right strategy and are excited about moving it forward piece by piece, making great progress on our supply chain, differentiated merchandise, new format and real estate selections. However, our initial marketing messages fell short in a few areas. We fully expected to see a positive 2-year stack in the back half of this year. And through the third quarter, we did not. With this in mind, we are focused on delivering a clear message that highlights our sharp produce pricing, innovative products and a farmers market experience to drive additional transactions in the quarters and years ahead.

Taking a step back, many of you remember, in the middle of 2019, we began our journey of a strategic transformation. The catalyst for that journey was recognizing the efforts to acquire new customers, primarily through an onslaught of aggressive and ever-increasing promotions would result in continued margin and brand erosion, which was not in the best long-term interest of our stakeholders. We immediately pulled back on many of the ineffective and unprofitable promotions and experienced a slight decrease in traffic as expected, but also improvements in our margins. Shortly thereafter, as we all know, COVID became a major factor. It impacted virtually all retailers in a variety of ways.

For Sprouts, one of the most important points to understand is that in the second quarter of 2020, we lost approximately 25% of our transactions. And to date, they have not returned. Certainly, COVID played a significant role in changing the shopping patterns of our customers during the height of the pandemic. Additionally, our change in promotional approach resulted in a loss of coupon clippers. What is encouraging is that those pre-pandemic customers that make up to 75% of transactions that have stuck with us are putting more units in their basket today than they did in 2019, paying higher average prices via a combination of mix, fewer promotions and inflation, resulting in a record third quarter profits.

Our sales in the third quarter of this year were up 5% and our earnings per share was up 155% when compared to the same period in 2019. The impacts of COVID have also reinforced our strategic direction, which includes the need to win with our target customers, refining our brand and marketing approach with everyday great pricing and unique product offerings, creating a supply chain that provides the freshest produce, while also updating our store prototype. Our prototype continues to provide our customers with a unique experience with differentiated product, yet in a smaller, more efficient store, resulting in higher financial returns and the ability to grow faster in new markets, building density and brand awareness.

Before providing more details relating to the quarter's activities, I'd like to turn it over to Chip, who will review our financial results and our outlook.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Thanks, Jack, and good afternoon, everyone. For the third quarter, net sales totaled $1.5 billion and comparable store sales were down 5.4% compared to the same period last year. On a 2-year basis, net sales increased 5% and our 2-year stack comp was down 2.1%. We experienced a slight sequential improvement each month of the quarter in both comp transactions and comp sales. From an e-commerce perspective, sales penetration stayed relatively flat at 10% and appears to be stabilizing at that level.

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Third quarter gross profit was $540 million and gross margin was 35.8%. The gross profit decline of approximately 130 basis points, which was in line with our expectations, was driven by the anniversary of elevated levels during the height of the pandemic and the balancing of cost inflation and retail pricing. We continually monitor market price points in all departments and are able to pass through most, but not all cost increases. Our margins are still more than 260 basis points higher than during the third quarter of 2019.

SG&A costs were $423 million, a decrease of $52 million when compared to the same period last year. The cost decreases were attributed primarily to lower COVID pandemic response costs, incentive compensation and marketing spend.

For the third quarter, our adjusted earnings before interest and taxes was $86 million, interest expense was $3 million and our effective tax rate was 23%. Our adjusted diluted EPS was $0.56, up 8% compared to 2020. As Jack mentioned earlier, compared to the third quarter of 2019, EPS was up 155% as we continue to maintain our margin structure through a more differentiated customer proposition. During the quarter, we opened 3 new stores, relocated 1 and remodeled 1. Both the relocation store and the remodeled store are in the new format.

Shifting to the balance sheet and liquidity. We continue to generate strong cash flow from operations, $297 million year-to-date. Through the third quarter, we invested $53 million in capital expenditures net of landlord reimbursements. During the year, we've also repurchased approximately $137 million in stock and ended the quarter with $250 million outstanding on our revolver, $20 million of outstanding letters of credit, $260 million in cash and cash equivalents and $163 million available under our current $300 million share repurchase authorization. We continue to maintain a low debt position, ending the quarter with a net debt-to-EBITDA ratio of nearly 0.

Now turning to our updated outlook for the year and our outlook for the fourth quarter. Total sales for the year are expected to be between $6.055 billion and $6.085 billion and comp sales down approximately 7% to 7.5%. Adjusted earnings before interest and taxes is expected to be between $325 million to $330 million. Earnings per share is expected to be between $2.04 and $2.08 and capital expenditures of $95 million to $105 million.

For the fourth quarter, total sales should be between $1.45 billion and $1.475 billion and comps down between 3% and 5%. Fourth quarter earnings per share is expected to be between $0.26 and $0.30. Lastly, we expect to open 9 new stores in the fourth quarter and 6 new store openings to shift to early next year due to difficulties in securing certain equipment from third parties because of supply chain delays. The total new store openings for 2021 is now expected to be 14, including 1 relocation.

Before turning to our initial outlook for 2022, I first want to discuss my reasoning for joining the company full time. Many of you have asked the question why or why now. First and foremost, I love this company, its people and its purpose of providing healthy living options at reasonable prices. Second, I believe this stage has been set for future success. We have a differentiated customer experience with unique product offerings and a new prototype that should allow us to aggressively expand our reach while creating shareholder value along the way. As we continue to learn more about those customers that love us and tell that message to those that don't know us, I believe we will slowly but surely turn the corner on comp store sales while still maintaining relatively stable margins.

Combining a low single-digit comp with our opportunity to grow stores should allow us to consistently produce high single-digit sales growth and high single-digit EBIT growth while producing sufficient cash for that growth without taking on any more debt. We should still have a significant amount of cash remaining each year to return to our owners, all of this with the backdrop of a current net debt position of essentially 0, while our equity is trading at approximately 5.5x our current year EBITDA.

What does all this mean for 2022? It's a bit early to be definitive around expectations, and we know we'll still be navigating some of the lingering challenges of COVID and inflationary pressures on cost and retail prices. That said, for now, we are expecting to open 25 to 30 new stores, of which approximately 65% will be in the fourth quarter. To be clear, 2022 openings are supported by a very strong pipeline of executed leases and approved sites above this level, but restricted as the aftermath from the pandemic continues to impact supply chains, city approvals and developments. Comps should be relatively flat, total sales growth in the low to mid-single-digit range and EBIT growth also flat.

With that, I'd like to now turn it over to Jack.

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

Thanks, Chip Let me speak more about the current business and our ongoing strategic initiatives. From a merchandising and innovation standpoint, vitamins, deli and grocery were some of the highlights during the quarter, boosted by back-to-school seasonal shopping from parents looking for better-for-you options for their children. Allergy-free items like healthy crunch jam and nut butter bars were popular in school lunch boxes this quarter and were among the unique items we highlighted in our new innovation center merchandising displays.

As kids returned to school and the spread of flu and the COVID Delta variant, sales in our immunity-based vitamin categories increased. And with busy families and more folks returning to work, we saw strong performance in our updated prepared meal solutions, sandwiches and sushi bar, driving growth in deli. For vendors and entrepreneurs, we are becoming the destination to launch new innovative products through our monthly Find a new favorite! program and other campaigns.

Good Catch's innovative plant-based breaded seafood line just launched nationwide with Sprouts. Dr. Bruno's entry into the brass category did an exclusive launch with Sprouts. I did signed with him almond nut chips.

Internally, we're also keeping the innovation train moving and held our first Al brand Vendor Summit with over few hundred participants. We have launched our own brand plant-based oat whipping cream and OATMILK NOG just in time for the holidays. As well, we have included new wood-fired flatbread pizzas from Italy, organic oat milk, the first of its kind in our dairy set and a vast probiotic program in the vitamin department.

In the third quarter, we also reset our wine department and created Sprouts' seller picks with over 50-plus new wines focused on transparency of ingredients and attributes like organic grapes are sustainably grown. These wines not only taste great, but they have also been beating our expectations. The wines, along with the other unique products mentioned, are driving home the best part of our farmers market, exploring new and exciting products from people and companies with interesting stories and passions.

Moving on to promotions and marketing. Our focus remains on adding profitable sales growth, getting more customers in the door and creating more loyalty with our target customers. Earlier this year, we fell short in communicating our commitment to great prices in our marketing, especially in produce. While it was present in store, we didn't effectively communicate our value message to our customers. We've begun to address this imbalance in the third quarter by trying new things, some worked, some didn't. For example, Bounce Back worked and even drove future visits after the second visit.

Special events in produce focused on our differentiation like tropical fruits or varietal grapes like moon drops and gumdrops drove more excitement in the store and were successful. We leveraged embedded call to action in our branding work. We highlighted our competitive advantage in produce, including attractive pricing, which is better than most and differentiated with more local new varieties and organic produce. We're being very deliberate in making measured investments in this regard and utilizing more of our owned media to share these messages.

Throughout the third quarter, our traffic slightly improved each month as we believe our customers responded to these new messages. During the fourth quarter, we're continuing many of these tests on a broader scale, and we are doing more mass media on Sprouts' strengths like promoting compelling high-perceived value items that are more relevant to our core customer. As well, we continue to refine our broader brand message and campaign to attract those new customers still unaware of Sprouts' differentiated store.

Just recently, we expanded the ways we share our wellness expertise with our customers. In October, we hosted an interactive wellness live stream with industry experts to discuss natural remedies for anxiety, inflammation and immune health, led by Maria Menounos, in collaboration with partners like Ancient Nutrition and The ONE. The panel spearheaded topics we're all thinking of today, how do I improve my health and feel better, which is likely why we received 20,000 RSVPs.

Turning to operations. No one is immune to ongoing supply issues and rising labor, product and transportation costs. Throughout stocks -- throughout supply chains, we are fortunate that we deal with smaller vendors to whom we're a big customer. This advantage allows our teams to continue to manage the health on the shelf, providing a great buying experience for our customers. That said, we are experiencing higher costs, most of which we are passing through outside of some fresh categories.

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We're experiencing lower labor applications like others across the U.S. and are working hard to keep our stores staffed by focusing on retaining our team members and making new offers quickly. To ensure team members are rewarded for their work in addition to base pay, our team members have access to incentive plans at every level in the organization. On the transportation side, the strategic change we made this year with the opening of 2 new DCs closer to our Colorado and closer to our stores in Colorado and Florida is mitigating some of the transportation cost pressures experienced in the industry.

The addition of the new DCs not only helped in costs, but they also help bring our local produce offering to life in stores. The Colorado growing season just wrapped up. The ability to source from local vendors was prevalent in all the regional stores in that state. During the third quarter, sales penetration of local produce in Colorado reached double digits, a level never before and greatly improved the freshness to our customers.

Now that we're in November, the Florida growing season is just kicking off. We're excited to be featuring 20-plus local Florida growers and over 100 local items during peak season, supported by the meet the grower marketing in the store. And we have high expectations of replicating the success we had in Colorado.

The third quarter marked a significant milestone along our journey with the opening of 2 new format stores. One was a relocation in Phoenix to a nearby site, and the other was a remodel of our Tustin, California store. Though it's early days for these 2 new format stores, I'm excited to share some highlights. First and foremost, the Phoenix location -- relocation is 23% smaller, and the sales are up significantly. The Tustin remodel store has not changed in size, but has all the elements of the new format, and its performance is encouraging. And the new format, produce remains the highlight, brightly displayed in the center of the store. Unique to Sprouts, we would meet to first in flow. We expanded and centralized our frozen department and presented more grab-and-go items in our deli department. The new stores are experiencing an increase in the percent of protein sales, and frozen is performing exceptionally well. Despite removing the expensive salad bar and prepacked deli options, deli sales are also performing above the company average.

Even though it is early days, these results give us confidence in the new format model. Over the next few months, we will open 3 more new format stores, and it will be the platform for our 2022 openings. We continue to learn from and develop this new format. The simplicity and smaller size of the new format will significantly reduce our cost to build and operate the stores. The cash investment to build is approximately 20% less by taking out the expensive daily fixtures and simplifying other areas like proteins. With smaller square footage comes lower cost to operate, be that in rent expense, improved shrink or other operational efficiencies like self-checkout. By utilizing our space more efficiently without having to reduce our SKU count in most departments, we expect sales to be at least equal to the larger boxes we built in the past, all resulting in improving returns.

Before I wrap it up, I'm excited to share some updates on the Sprouts Healthy Communities Foundation. In 2021, we are supporting 150 nonprofit organization with grants totaling $3 million, continuing our work to support our communities with access to fresh, nutritious food and empowering children with the knowledge and resources to live a healthier life. And this weekend, we have our National Day of Service, where over 500 Sprouts volunteers will complete 50 service projects across the country. Through the help of the foundation, we all get our hands dirty by supporting the local school and neighborhood gardens we have helped create over the years, which is a great event to give back to the communities who support us.

I emphasize we have work to do. And while we're disappointed in the third quarter top line, the strategic transformation is progressing well. Our journey to improve upon the Sprouts model is well underway from our new innovation centers, our 2 new distribution centers, our measured promotional approach and our new format stores. We are confident in the ability of the long-term strategy to create a more profitable and sustainable company for many years to come.

At this time, let's open up to questions. Operator?

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Scott Mushkin with R5 Capital.

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

So I think, obviously, a lot of questions around the kind of sales performance as the company goes forward into the fourth quarter into next year. So I was wondering if you can kind of give us some thoughts about what the gross margins you guys think will look like as we go into the fourth quarter and how much investment you think there needs to be to get that traffic and sales line moving.

And then as we think of '22, which I think you said EBIT was going to be kind of on the flat side, you'll kind of take us to the idea of where we grow, where will margins be, doesn't have to be exact guidance. But clearly, there's a lot of people in the market that don't think you guys can do this. And so I was wondering if you could maybe tell you why you think you can.

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

Well, I'll let Chip go through in a bit of detail some of the margin dialogue that we've been having. Fundamentally, we've reshaped the margin, as you know, Scott, over the last couple of years, and we're in a position where there may be some tweaks we need to do to invest in it. But by and large, we've got our margins where we need to get them to be, and the focus of the business over the next quarter and next year is how do we get the comp sales to that moderate comp sales that we talk about.

And there's kind of 3 buckets in that. It's how do you grow the basket, which the stores are doing a nice job in chasing after that. It's how do you grow transactions from existing customers. And we've seen some success in some of the marketing activities in that, whether it be the Bounce Back or something to our sales, we've seen something in that. And then the next stage is how we grow new customers. We probably need to think a little bit about how and where we invest in our marketing dollars to drive that going forward. But I'll let Chip talk a little bit about the margin.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. Scott, in the fourth quarter, just to be specific, I think on the fourth quarter, the gross margin is going to be down year-over-year. It won't be down as much as it was in the third quarter, call it, 70 to 80 basis points in the first -- it's kind of early for next year. I do suspect that we'll still be down year-over-year going into the first quarter. But year-on-year, we're aiming towards flat for next year.

On gross margin, there are some opportunities in sort of the non-merchandise margin areas to help mitigate some of the, I'll call it, inflationary pressures that you have on margin as well as we're going to continue to test and measurably test and aggressively test lots of ways to promote in a way that still kind of manages the margin within our ability to do that and drive sales without burning the bottom line.

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

And as a follow-up, we get this question also a lot from people. Around the format itself, do you think it's differentiated enough in the marketplace? Or do you need to do more to bring those people in, to have people understand that Sprouts is different and to kind of draw them in a more aggressive kind of pull model versus pull people in? And then I'll yield.

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

Well, in terms of the specifics of what's inside the store in terms of how does that differentiate us, I do think the fact that we've got produce in such a prominent place, and that's such a key part of the whole Sprouts proposition, reinforcing that and doubling down on that is something that is a

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differentiator for us, especially the level of our pricing relative to our competition in produce. We probably need to talk a bit better about that. But I think that what we're actually doing in the format store worked in that respect.

I think the vitamin department is something that, especially in the world of immunity and people worrying post-COVID about lots of aspects of their health, we see that as a fairly key differentiator. The people that we have working in that department really do add significant value, and I think that's a key part of the differentiation. What we've done over the course of the more recent times is these innovation centers and bringing key innovative products into the store, which weren't there before. I think that's something, again, we should talk about a little bit more, but does provide a very clear differentiation. Selling products that other people don't sell is as differentiated as you can get, and it's how we talk about that more effectively.

And I think we are becoming the kind of destination for a lot of the small brands as to -- if you want to get started with your small brands, Sprouts is the ideal place to do that. And the team are working very well in terms of bringing those things in. And I think private brand will play an even bigger role in that innovation going forward. So when it comes to innovation, produce, vitamins, I think we do have differentiation, and increasingly, our grocery fixtures, the level of assortment that we have around keto, paleo, gluten-free, that, again, maybe we need to talk about a bit more assertively. But the kind of diet space that we occupy and the authority we have in that space, I think it brings us differentiation.

I think the question -- inherent in your question is are we doing enough to pull them into the store, and I think that's something that we're working at pretty clearly. Are we tell them the message clearly enough? And that's something that we'll be doing a lot of work on over the next quarter and beyond.

Operator

(Operator Instructions) Our next question comes from Matt Fishbein with Jefferies.

Matthew Jacob Fishbein - *Jefferies LLC, Research Division - Equity Analyst*

As I think about like the top line trajectory from here, I know you pointed to the past couple of months' sequential improvement, how did October look relative to the previous 3 months? And related to that, as it relates to marketing dollars, where do we see marketing dollars next year going? Is this a case of there not being enough marketing dollars spent? Or is it simply, like you were explaining, the tactics involved with those marketing dollars?

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

Let me talk about the marketing position, and maybe Chip can comment on October and the traffic in terms of what's been happening. Specifically around our marketing dollars, we're wrestling with what the right amount to spend is. And it's more about tactics than it is about -- we've got a lot of resources in marketing that we spent a lot of money in the past, sending out very highly aggressive promotions on paper flyers. We've taken that out. The COVID pandemic allowed us to do that faster maybe than we would have done otherwise, but it's certainly given us a lot of ammunition if we need to use it. In Q3, we were fairly judicious about how we spend our marketing dollars as we wrestled with the right tactics. And as I said in my remarks is -- some of them have worked, and some of them haven't, and we're learning from that.

I fundamentally believe, as I said in the last comment, was that we've got to tell the story of what the key differentiator of Sprouts is more effectively. And that simply goes around on pricing on produce where, in some markets, we're 30% to 35% cheaper than our competition on it. I don't think our customers know that well enough when we're not doing such aggressive high-low. So our EDLP pricing on projects needs to come to the fore a little bit stronger in a tactical sense. And then the second aspect is how do we make our innovation much clearer to the potential customers that we have.

And then these buckets are driving costs. Some of them require marketing. I think we can grow the basket in the store by doing the things we've been doing in terms of putting innovation in there, getting the stores behind new varietals and driving behind the produce business. We can grow

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that without marketing. I think there's aspects of how we grow the transactions with our existing customers that we've seen some success in our marketing dollars.

And then the final bucket, how do we get new customers who look like our existing customers? And I think there is some marketing messaging tactics that we'll have to put some resource into it going forward, but it's not beyond where we've been in the past in terms of how much money we need to spend on marketing. Maybe talk traffic, Chip.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. And Matt, this is Chip. As it relates to October, we don't typically provide guidance by the -- or provide information by the month. But we guided for the quarter minus 3 to minus 5. We feel good about October as it relates to that guidance. November and December, which has been factored into that guidance, was pretty good last year because there was a resurgence of COVID towards the end of the year, which makes it a little bit more difficult in November and December from a year-over-year comparison. But we feel good and feel confident that we're going to be in that 3 -- minus 3 to minus 5.

And then a little bit on the marketing spend front, too. I think it's good to know that we're continuing to test quarter-over-quarter from Q3 sequentially to Q4. We are spending more money in marketing or at least we're anticipating spending more money in marketing, not just to test and learn, but also to help us set off the year right for next year. And then year-over-year, we're spending a little bit more in Q4 than we did last year.

Matthew Jacob Fishbein - *Jefferies LLC, Research Division - Equity Analyst*

Yes. All makes sense. And just as my follow-up, I know that cost inflation is usually for conventional grocers, at least, in many ways, a tailwind to the top line. Can you just remind us -- remind me specifically, why Sprouts and maybe specialty grocers may not experience that tailwind the same way? And how do you expect that total impact in '21 to look relative to '22?

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

Well, specifically around -- we've seen an AUR increase in line with much of the marketplace around the inflationary pressures. Products that we sell that the rest of the market sells, things like proteins, meat, very specific on a lot of our produce. We're seeing the same sort of levels of inflation that you're seeing across the conventional grocery space. And I think as I said in the last call, around the product -- we sell a lot of products that other people don't sell. And there's probably a lag a little bit. We talked a little bit about a lag when you've got a lot of small-volume products and a lag flowing through in terms of inflationary pressures.

So we've seen big inflationary pressures in our meat, in our pork, in our chicken, in our salmon, in our fresh produce, and we're not seeing the same extent in our grocery business. It's much more muted and more measured in that space. Maybe something will come on that in the future. As you go into 2022, I think it's kind of -- your guess is as good as mine in that. We're certainly seeing the level of increase in our protein business smoothing out over the course of the last few weeks. It's going up, and it's smoothing. And I think you'll start to see it going in the opposite direction at some point as the economy kind of slows down a bit. But we are certainly comfortable that in most commodities , we're able to pass on what's been passed on to us apart from 1 or 2 areas in our protein space.

Operator

Our next question comes from Ken Goldman with JPMorgan.

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

You've given some answers to this already, but I wanted to explore a little bit more the commentary about flat or flattish comps in 2022. It's a little bit lower than what the Street was expecting, especially if your margins are already where they need to be. So I'm just trying to kind of parse out what some of the headwinds are that would hold you back from a positive number. Is there an element of uncertainty here because of the macro trend back to away from home? I just wanted to kind of get a -- more of a complete list, if I could, of what would hold you back from a positive number there.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Ken, this is Chip. What would hold us back is, one, it's early and there's a lot of uncertainty in the marketplace. As Jack has already alluded to, inflationary pressures, how does that play out, where does that go, what does that do to the consumer as you start to see while it's getting squeezed in the marketplace, where -- what does that do to a secondary or tertiary shop or a secondary or tertiary item. It's just too early to bet on something that's higher.

I much prefer us plan for something that's lower, plan our cost structure accordingly for that. And then as we get through these test-and-learn spaces, the more we can learn about where we can drive traffic with marketing dollars or promotions, we'll then go forward and we'll continue to do that profitably going forward. But at this point, I'd rather us plan around the idea that it's going to be closer to 0, and we can work our way into something better as we learn more.

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

Okay. That makes sense. And then you did talk about, again, your margins kind of being in that range you want to be. You talked about the gross margin next quarter. I wanted to get a sense because your SG&A dollars have come down each of the last 5 quarters, obviously, a pretty high number during COVID. Are we at more of a level $423 million or so, where that's kind of a run rate going forward. I know it's not going to be exactly the same every quarter, but I'm just trying to get a sense for how low we should think about that going ahead.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. Sure. I think if you look at it, we have -- in the third quarter, we did have -- as with the second quarter, we had a lot of SG&A reductions year-over-year, predominantly driven by COVID, our COVID-related costs last year. We are beyond that going into Q4. Our SG&A is expected to grow year-over-year in Q4. The math -- you guys can back into what the math of that is with the other metrics that we've provided.

And going forward next year, based on the guidance -- not guidance, but the sort of initial outlook next year, we're going to -- we're not going to go backwards in costs. We're going to continue to grow costs from this point going forward. It's just we got to monitor and measure and make sure that we don't -- we got to be prudent about how we grow it going forward.

Operator

Our next question comes from Mark Carden with UBS.

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

First, a bit on the comp question that we just had. But are you guys able to measure how far you are today with respect to shedding some of the less profitable coupon clippers? Are we almost past this headwind? Do you still think there's ways to go? And then are you seeing any different customer mixes at your new format stores versus your legacy stores?

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

Yes. Both very good questions, Mark. First of all, the confusion that's come with COVID, we talked about losing 25% of our customers over the course of the immediate aftermath of the COVID and that. Since then, it's been relatively static. Of that 25%, we think, and this is an estimate that we've got, the 15% of those came from the COVID environment, and 10% probably came from the change in the promotional strategy that we fully aggressively implemented a little while ago.

And since then, it's been a kind of pretty static mix, pretty consistent in terms of the way the customer -- some customer -- more customers have drifted off, but some customers have drifted in as well. So where that will go, I think it will flatten out. I think it's kind of getting towards where it's flattening out pretty quickly now that we're in a position where you shouldn't see the promotional impact being a cause of further dilution in traffic. Going forward, we believe it will go in the opposite direction if we can get our marketing right and our execution right. But by and large, we're kind of at that flat point.

As we go into the 2 new stores that we've reopened, I think we're seeing, not just in the 2 new stores, but across the board, some encouragement in our target customer base and that they're spending a little bit more with us and putting a little bit more in their basket. So we're seeing some trends to that effect, but it's kind of early days because we've only got 2 of them, and there's a broader context going forward as we move into this. We would expect that to be the case, but I've not got enough data to really back that up right now.

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

Okay. Fair enough. That makes sense. And then on in-stock levels, you talked about your advantage of working with some smaller suppliers. Obviously, still some challenges everywhere. But how are your in-stock levels trending relative to what you've seen in recent quarters throughout COVID and relative to where you'd like to be really in a more normalized environment?

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

Yes. I think -- I don't know when we're going to get to a normalized environment. There's certainly a lot of challenges in in-stock for us. One of the issues for us is we've got a big SKU count. So if you're out of stock of one thing, I think there is an opportunity for customers to move around within our assortment. So that mitigates somewhat our in-stocks.

I would say our in-stocks have got bad in the start of Q3 and maybe got marginally better towards the end of Q3. But it's a constant battle at the moment, trying to get things through the network. And as much as anything else, it's about product, but it's also about transportation and drivers and getting people into our warehouses and getting people into our third-party distributors. So I would say it was tougher at the start of Q3, getting marginally better, but it's still a tough challenge at the moment.

Operator

Our next question comes from Krisztina Katai, Deutsche Bank.

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

I guess, I wanted to go back to your call-to-action test that you have been doing for the past 3 months. And you did say that the ones that focused on your differentiated produce mix resonated with customers. So maybe if you could just share a little bit more in terms of how did these translate to potentially improve store traffic and what are maybe some of the early learnings from customer engagement and loyalty building perspective that you can go forward from here.

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

Well, we're going to have to go -- I'll come to loyalty in a second. In terms of the activities that we did, in terms of our testing through Q3, certainly, when we put produce products in there and we think of differentiated varietals of grapes, they've worked really well for us. When you get flavors and tastes and we get sampling, one of the things that's helped us in Q3 a little bit is we managed to get some sampling back into the stores. And if you can get the experience of tasting products that you can't get anywhere else, we do believe that's a loyalty builder for us. And we're excited about doing much more sampling going forward around the differentiated products that we have.

And also our innovation centers that we've been putting into store where we've got new -- completely new products, whether it be in chips or whether it be in health-focused products, whether it be in drinks, we've made some real progress in bringing products in. And I would like us to be doing a lot more in terms of getting sampling and tasting for the customers when they come in to drive a lot more kind of loyalty in the future around those things.

Testing and marketing, the ones that kind of worked for us, we did this Bounce Back campaign where customers -- we didn't do it everywhere, but we did it in certain places where customers get the receipt, and then they can come back a few days later. And I think that encourages our existing customers to have more frequent transactions. So we think that's worked quite well for us, and we did a 72-hour sale on specific products that seemed to work quite well for us as well. But there are some other ones that didn't work. As I said in my remarks, it's been hit and miss. We've had some wins and losses in that exercise.

Going forward on loyalty, we're doing a lot more work in terms of trying to understand our target customer base with a lot of different sources of data up to and including how we might think about, do we go how much further, do we use e-mail marketing, how much further do we use getting the information on telephone, on phone numbers and using text marketing, which seems to be a fairly significant trend in the industry at the moment. And I think we can do a lot more text marketing going forward as we build the number of people who are giving us that information, and we're getting a few more people in that space now.

So that loyalty, that is going to come around text marketing and e-mail marketing and how we can take that information in a more clear way. And the idea of loyalty card is clearly part of our dialogue going forward as we think about it.

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

That's great. And I wanted to follow up on some of the inflationary comments that you made. You said that your -- the grocery side is much more manageable, but you're seeing, obviously, a lot more inflation on the fresh side. How much were you able to pass through in the third quarter? And have you seen any customer resistance to higher prices in some departments perhaps where the change of rate has been more rapid?

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

So I think I'll let Chip comment as well. But fundamentally, we've seen some pretty significant cost inflation on beef, chicken, pork and salmon. And we've seen -- we've been able to pass on some of it, but not all of it. And we have seen some resistance to some of the price points at the top end of cuts in the meat space. And we've seen some trading down and around within the protein space.

Produce has seen an increase, not double-digit, just below double-digit. And we've been able to pass on produce pricing, and it hasn't -- we haven't seen too much resistance in that space. So the rest of the business is pretty manageable, as we said, but that would be where -- the one place where we've seen some resistance would be in the beef and protein space.

Operator

Our next question comes from Edward Kelly, Wells Fargo.

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

Could you just talk about the store openings continue to get kind of pushed back a little bit? Can you just talk about what you're seeing there? And then it did sound like in the guidance when you talk -- or at least the longer term about the low single-digit comp and high single-digit sales, but maybe we're not talking about 10% store growth. Just kind of curious if there was some subtle change there as well.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. This is Chip. Well, number one, we -- in the near term, what we're seeing is we have a great pipeline. So we're continuing to go and find great sites that we fit -- we believe will fit for the Sprouts model. The challenges we're having today are, one, they're -- getting through permitting is a challenge around the country for everyone that's trying to build anything. And then also on construction, trying to get the construction completed and also the sourcing of the equipment. All of that is becoming challenging.

We did have a pretty back half loaded, Q4 loaded, a number of new stores this year as we did next year, and it's become a little bit of a dominoes effect as you start to see some of these challenges. Do we believe we can get back to the profile of doing a double-digit unit growth? Yes, I think we can get back by -- hopefully, depending on -- we all don't know how COVID is going to -- or how these impacts in the supply chain are going to factor into '23 and beyond. But right now, we're very hopeful that by the time we get to '23, we can get back on a clip of 10% unit growth a year.

That being said, a new unit is not going to deliver -- it's not going to be fully mature. So if you just do the math, you're doing 10%, you're going to get slightly less than 10% top line growth on that. And you combine that with a very low single digit, you get to that number. Could it be a little higher? It could be, but that's kind of how we think about it now for '23-ish and beyond.

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

And the leases in the pipeline is in good shape, Ed, in terms of what we need going forward. Just the dates at which we get them opened is it kind of been a crazy time for everybody. But then as Chip said, the permits and the construction and the materials and -- has just been a real challenge in terms of getting to where we want to get to. But it's not that we've changed direction. It's a piece of which we're going to be able to -- and we want to be clear about what 2022 can do.

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

And then can you just talk about what the mix of the new stores are going to look like going forward, newer -- let's call them newer markets like Florida as opposed to existing markets and then what you are seeing in those newer markets in terms of store ramp, how long it takes for stores to get to profitability and how that -- this ramp of the store growth, both this year and next year, just to consider how it impacts the P&L.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes, certainly. All of our new stores going forward in '22 and beyond as planned are of the new format. So they'll all be the smaller stores, new format. Our expectation is that the average unit volume won't be dramatically different than they have been historically, and the ramps should not be much different than they have been historically. So that's the way that I would think about it going forward.

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

And from a geographic point of view, we clearly have different expectations in markets where we're not as well known in terms of the time that it happens. And consolidating Florida has been an interesting kind of exercise for us as we try and get consolidated within markets, whether it be

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Tampa. More -- the fact doing smaller stores allows us to get a little bit more concentration in a market, which allows us to get the marketing spend at the right level to start with.

So certainly, Florida is one that we're very excited about going forward. We've got the distribution center, and we've got a ton of leases in place to be able to build a critical mass in some of the key conurbations down there, and we remain excited about how that's all going to play out.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

And I would add to that is it is very clear to us that density matters. It matters from a brand perspective. It matters from an opening sales volume perspective. The ramp may be a little bit dampened because it's in a market that's established. But the opening volume is higher in an established market, and the profitability is higher in established markets. So as we get into these new emerging markets like Florida, like the Mid-Atlantic, it is really critical for us to get some density in those markets from a brand awareness perspective and get to the volumes that we believe will really drive shareholder value.

Operator

(Operator Instructions) Our next question comes from Brandon Fletcher with Bernstein.

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

I appreciate the time. My question is pretty simple. I think the strategy makes sense, and we track on the differentiation. One of the things that's been odd to us is that some of the other grocers that may have kind of comped the comp a little bit better, we certainly perceive as having less of a strategic move, meaning the differentiation isn't there. The service level isn't there. But maybe the comps haven't suffered quite as much. And so the puzzle we've been trying to solve through, which you gave us a little color on, is you had to let go of some of the kind of the less profitable coupon clippers. But we're curious as kind of you have a view as to how folks that have less differentiation may have been holding up a little bit better kind of on the comp-to-comp battle because I think that's kind of the weight that hangs on what is otherwise a really positive story in our view.

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

Yes. I think it's a good point. I think when I look at the conventional you're comparing the comps to, I do believe that the COVID environment that consolidate -- clearly, the number of shops that people make to buy their grocery shopping has gone down through the pandemic from something like 5 to 2. And as it's gone from 5 to 2, the consolidation of the shop around the conventional grocers has probably helped enable them to hold out their comps better than ours over that period of time. And I think it's beginning to change a little bit, and we might get some benefit of that bouncing back the other way.

When I look at what's happened in the course of the marketplace, the broader marketplace, the mass channels and the club channels can add -- well, the club not so much, but certainly the mass channels struggled a little bit to start with. They're bouncing back pretty hard on the numbers at the moment. So the conventional grocer is probably suffering a little bit on that going forward. We tend to not focus too much on what other people's comps are. We focus very much on being -- we are a complementary retailer, and we believe our comps are kind of controlled by our own destiny that if we get this right and do the right thing, that we'll be in a position to drive the additional share of wallet that we need from our target customers. And there's plenty of dollars out there for us to get to the kind of modest low single-digit comps that Chip has been talking about that we can get there within our own world, almost irrespective of what happens to the other guys. But in simple answer to your question, I think it's the COVID environment that's made that difference.

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Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

And I would also add, Brandon, I think we've made it in the opening comments. But it is encouraging when you think about -- I mean when we lost 25% of the transactions in the second quarter of 2020, certainly, that's a challenge. And the fact that they haven't come back is a challenge. But the idea that those 75%, as Jack mentioned, they're putting more units in the basket today than they were in the third quarter of 2019. And they're paying significantly higher prices, both through mix as well as inflation today than they were in 2019. And we need more of those customers and drive those customers. And then the icing on the cake is we can get those 15% that left because of COVID who may be, for a variety of reasons, it's a secondary shop, it's a tertiary shop, inflation is squeezing their basket, whatever. If we can get some of those back as well, we can win.

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

Yes. That makes a lot of sense. So when you go from 5 to 2 and then eventually back to 3 because we're not going back to 5, the idea would be that those customers will have a reason to add you as the trip. And if you message that right, then you get the magic of a little bit of extra comp flowing through so beautifully through the P&L. And so I think that makes sense to us. And as long as you guys think about it that way, I think we understand it well.

Operator

And the next question comes from Rupesh Parikh with Oppenheimer.

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

So I had 2 related questions on just capital allocation. So just given some of the changes in new store growth at least for next year, just curious how you think about CapEx as a percent of sales going forward. And then also, I guess, just related to that, given where your share price is today and the multiple at which it trades, does anything change in terms of how you guys approach share buybacks? I know the pace in recent quarters hasn't necessarily been that aggressive.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Rupesh, it's Chip. As it relates to CapEx, we haven't provided a number, but I think -- honestly, I think Denise said, what about 3% to 3.5% a year.

Denise Paulonis

Yes, 3.5%.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. It's probably, call it, 3% a year. We'll give you more specifics for next year, but it should be about 3% of sales from a go-forward perspective. And then as -- which, obviously, that leaves a lot of excess cash coming out of the business.

Capital allocation, we're going to continue to evaluate our options. We'll continue to -- we want to give money back to our owners in some form or fashion. The pace of that, we'll just -- we're going to play it by year, and we'll opportunistically buy.

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

Okay. Great. Maybe just one follow-up question. So as you look at SG&A, same thing in FY '22 and beyond, like what type of leverage point -- what type of comp do you need to leverage SG&A do you think going forward in the current cost backdrop?

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Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Well, that's a question that everyone asks and has for 20 years. But it always depends on what you're managing year-over-year. So right now, for next year, our expectation is that our SG&A, we're going to try to manage it at least going in, in that, call it, 6%, maybe 7% growth, somewhere in there, 5% to 7% growth. And we're not going to get earnings growth on that number. So if you really want to leverage SG&A consistently as pretty much any retailer, I think you need a 2% to 3% comp if your margins are stable.

Operator

Our next question comes from Karen Short with Barclays.

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

I just had a couple of questions on next year in terms of the comps. Can you maybe just give me a little color on how you think that the composition will be with respect to traffic versus basket and versus inflation? Because I don't know that I've heard that clearly from you. And then I had another follow-up.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Well, Karen, we haven't actually said it. So that's...

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

I didn't hear that.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes. That's why you probably haven't heard it. Look, it's really early for us to -- and there are so many -- it's like a lifetime away, 2022 right now. That said, how are we thinking about it? We really want to get our traffic back to at least neutral. And so if you think about that, you got to get the traffic back to neutral. Right now, I don't see that it's quite back to neutral. And right now, I think that we'll be -- we'll get some AUR with inflation. I'm not so sure the units in the basket, especially when you're looking at where you're comping. I don't think the number of units per basket will increase. I think they'll be flat to down, and then you do the math and you kind of get to a 0-ish comp. Can we do better than that? If we can get traffic going -- if we can get traffic positive, we'll have positive comps next year.

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

So the 3 things that drive our comp if we get it right, as I said earlier, one will be growing the basket for people that are in the stores, which is going to be part of our comp drive, both basket -- both units and AUR. Grow transactions from our existing customers so that the customers that come with us come more often because there's a reason to do that, because there's something new all the time, because the fresh foods is developed, new products, new varietals, new products coming in, the innovation center, sampling. There will be people coming on that basis. And then the third bucket is growing new customers from an effective marketing campaign. All of that should add up, I would have thought. In terms of transactions, a pretty flat transactions number going forward. That would be our aspiration.

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

Okay. And then can you just -- obviously, again, we're not in normal times. But can you just remind us on when you or -- and/or what you're seeing now in terms of the comp waterfall specifically? Because, obviously, and Jack, we talked about this, as a growth company, everyone looks to your comp waterfall. And your comps obviously don't reflect that you're gaining share at all even in new stores, let alone existing. So maybe a little color and update on your thoughts on that.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Your definition of comp waterfall is transactions, units for ticket, units and AUR?

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

No. Just as in you open stores, and they open at a certain percent comp, right, or they mature at a certain percent on your...

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Got you. You sum up the ramp.

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

Therefore -- yes, yes.

Lawrence P. Molloy - *Sprouts Farmers Market, Inc. - CFO*

Yes, if you get to the ramp. If we're doing 10% square footage growth, we're probably getting a 1-ish comp out of that on a 10% square footage growth. And so next year, we're not -- we're going to be, I think, around 7% square footage growth. So we might get a little bit less than 1 on that.

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

Okay. That's helpful. Because I do think there was an issue where some of the stores you opened at a certain point in time were actually much higher-volume stores. So you may have been negatively impacted by higher volume cycling in, but I just want to clarify that.

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

We certainly used to open stores with more aggression in terms of promotions and took a lot more time to get back to kind of paying back that investment. So I think that's probably what you're alluding to, Karen, in our previous dialogues.

Operator

I'd now like to turn the call back over to Jack Sinclair for closing remarks.

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

Thanks very much, everybody, for taking the time. We really appreciate your interest in our company, and we look forward to continuing the dialogue and helping to make this whole, exciting venture come alive. Thanks, everyone, so much.

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Operator

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

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