REFINITIV STREETEVENTS

EDITED TRANSCRIPT

SFM.OQ - Q3 2022 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 08, 2022 / 10:00PM GMT

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

CORPORATE PARTICIPANTS

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

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

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

CONFERENCE CALL PARTICIPANTS

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

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

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

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

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

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

Michael Lasser *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Robert Bain Moskow *Crédit Suisse AG, Research Division - Research Analyst*

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

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

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

PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Sprouts Farmers Market Third Quarter 2020 Earnings Call. (Operator Instructions) I would now like to turn the call over to Susannah Livingston. You may begin.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our third quarter 2022 Earnings Call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Chief Financial Officer, are with me today. The earnings release announcing our third quarter 2022 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 2022 and beyond. These statements involve several risks and uncertainties that could cause 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 and the commentary on forward-looking statements at the end of our earnings release. Our remarks today include references to non-GAAP measures. Please see the tables in our earnings release to reconcile our non-GAAP measures to the comparable GAAP figures.

With that, let me hand it over to Jack.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Thanks, Susannah, and thanks to everyone for joining us today. Despite many of the current challenges in the consumer landscape, we're encouraged by our performance in the third quarter, which included total sales growth of 5%, comparable store sales of 2.4% and earnings per share growth of 9%. I want to thank our 31,000 team members for their continued dedication and commitment to making Sprouts the ultimate destination for discovering healthy eating and wellness options.

Our customers count on us to be a leader in innovative, high-quality and healthy products in a unique and inviting shopping experience. I would also like to highlight the efforts of our operations, supply chain and human resource teams in supporting our Florida stores and the communities they serve during and after Hurricane Ian. Fortunately, 100% of our team members were safe and all our stores and the Orlando distribution center were up and running within 4 days of the storm's passing.

I would also like to thank all our supply partners who played a vital role in successfully navigating the storm. We believe we are making progress in delivering expectations for our customers, team members and shareholders. We had a solid third quarter and expect continued progress in the quarters ahead. In a few moments, I'll follow up with more details about our recent activities and the remainder of 2022.

For now, let me hand it to Chip to review our financial performance in the third quarter and our current outlook. Chip?

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

Thanks, Jack, and good afternoon, everyone. For the third quarter, total sales were $1.6 billion, up $81 million or 5% from the same period in 2021, driven by new stores and comparable store sales growth of 2.4%. Comp sales were supported by an increase in basket due to retail inflation, partially offset by a slight reduction of items in the basket. Our e-commerce sales grew 19%, representing 11.1% of our total sales for the quarter. Deli continued to be a top performer as customers sought Sprouts as a destination to fulfill their appetite for healthy prepared meals and grab-and-go options such as sandwiches, salads and snack boxes.

The other categories of strength were where we have the most innovation and differentiation, including bakery, grocery, dairy and frozen. Our third quarter gross margin was 36.7%, an increase of approximately 90 basis points compared to last year's third quarter. The majority of the impact was driven by the fact that we were less promotional this year than last year when we were testing a variety of promotional and pricing tactics.

SG&A for the quarter totaled $461 million or $37 million higher when compared to the same period last year. The increase was driven by new stores, higher wages and additional marketing spend. Last year, we shifted marketing dollars into more promotional activity. E-commerce fees were also higher due to the associated increase in sales, while credit card fees are rising as more customers shift from debit to credit.

For the quarter, our earnings before interest and taxes were $90 million. Interest expense was $2 million, and our effective tax rate was 26%. Third quarter net income was $66 million and diluted earnings per share were $0.61, an increase of 9% compared to the same period in the prior year. During the third quarter, we opened 1 new store in Moreno Valley, California, bringing our total to 9 for the year so far.

Turning to the balance sheet and cash flow highlights. We ended the quarter with $316 million in cash and cash equivalents, $250 million outstanding on our $700 million revolver and $25 million of outstanding letters of credits. 100% of our $250 million in outstanding debt remains fixed with our interest rate swap through the end of this year. Cash flow generation in the third quarter remained strong. We generated $98 million in operating cash flow and spent $25 million in capital expenditures net of landlord reimbursement in the third quarter. This robust cash flow generation allows us to invest in the growth of our business while also returning cash to our owners through our ongoing share repurchase program. For the quarter, we repurchased 1.6 million shares for an investment of $44 million. For the third quarter, diluted weighted average shares outstanding were down 6% from last year.

Turning to our expectations for the year and the fourth quarter. For the full year, we expect total sales growth to be in the range of 4.5% to 5% and comp sales of approximately 2%. Earnings per share is expected to be between $2.32 and $2.36. We expect capital expenditures for the year, net

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

of landlord reimbursements, to be between $120 million and $135 million. For the fourth quarter, we expect comp sales of approximately 2% and earnings per share between $0.35 and $0.39. We also expect to open 7 new stores during the quarter, bringing our total for the year to 16.

Given the current uncertainty in the marketplace, it's a bit early to guide for next year other than the opening of at least 30 new stores. That said, we are committed to controlling what we can control to drive meaningful results.

Before turning it over to Jack, I'd like to share an update on the Sprouts Healthy Communities Foundation. I've had the good fortune of serving on the Foundation Board over the last year and have been unbelievably impressed by the Sprouts passion for the mission of helping children learn to grow healthy. Through the foundation, Sprouts actively supports 130 nonprofit organizations that operate thousands of vibrant school gardens that provide students with hands-on gardening, cooking and nutrition education while reinforcing academically what students are learning in the classroom.

This year, the foundation has supported programs that benefited an estimated 3 million students. Our team members also help bring this work to life through their hands-on support, volunteering to help build and maintain many of these garden spaces. This Fall, we hosted our annual Sprouts Day of Service where 700 team members donated 3,000 volunteer hours to support the foundation's mission. We want to thank all that took time to participate in these events. And with that, I'll turn it over to Jack.

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

Thanks, Chip. Today, I'd like to highlight progress in those key focus areas that enable our ongoing profitable growth and deepen our relevance with the consumer. After that, I'd like to touch on the here and now, what's happening with our customers during these unprecedented inflationary times and how we responded. First, on the real estate front. A few years ago, we set out to open 10% new stores every year. We've not delivered on that goal given the permitting and supply chain challenges created by the pandemic. This year, we will open 16 new stores, and the trend is improving. We expect to open at least 30 new stores next year on a path to 40 plus by 2024.

Recently, we completed the implementation of a new real estate tool. This tool does 3 things for us. One, it provides details of the Sprouts white space for every MSA in the country. Based on the tool, we believe that our brand can support 1,350 total stores in the Continental U.S., an incremental 970 from where we stand today.

Second, it identifies the absolute best location for our Sprouts store within a trade area, essentially Main & Main. This enables our real estate team to be more proactive in sourcing the very best sites. And third, it provides a more accurate sales forecast for each location, helping us avoid potential underperforming stores. As we've mentioned many times this year, another area of focus is in-stocks. We expect to complete the implementation of PICAO or perpetual inventory computer-assisted ordering by the second quarter of next year. Recently, we also invested in an on-shelf availability solution that provides a single source of the truth for product availability as seen from the customers' eyes. The combination of these 2 tools should support incremental sales, improve margins via the reduction of markdowns and shrink, and free up task-related labor hours in the store so that our team members can spend more time better serving our customers.

Moving on, product innovation and differentiation are critical for Sprouts. It creates an environment of ongoing discovery and helps reinforce customer loyalty. We partner with over 250 local farmers on the produce front to help build strategies around unique varieties. Today, we have over 300 local produce items in our stores, almost double that of last year. And by the end of 2024, we expect 20% of our produce sales to be local.

Outside of produce, we're doubling down with "Our Brands". So far this year, we've launched an additional 400 private label products and repackaged more than 450 with an updated design that highlights vital product attributes and is also considered more appealing based on customer surveys. "Our Brands" non-perishable sales growth during the third quarter was more than double that of branded products.

Our merchants also continually seek new and innovative products from the vendor community. In grocery alone this year, we've launched more than 300 first-to-market products, many of which are exclusive to Sprouts for a period of time. Lastly, deli has no shortage of innovation as we curate our unique meals and offerings that taste great and are good for you. Deli had been our highest growth category this year.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

The last key area of focus that I want to highlight is in the customer analytics and loyalty arena. In the previous 2 years, we've built a true customer analytics team, and are working diligently to understand our customers' behaviors and desires better. We have a long way to go, but it's a journey that starts with connecting. And during the third quarter, we increased our active e-mail accounts by 19%, our SMS accounts by 42%, and our mobile app downloads increased by 15%. Today, we can link approximately 16% of our total transactions to individual customers compared to just 12% a year ago. Approximately 7.5% of transactions are tied to loyalty customers, up about 50% compared to last year, and their baskets are almost 70% higher than non-loyalty baskets. We've also completed some early testing on targeting and personalization efforts with encouraging results. This will take time to scale, but will provide opportunities for Sprouts in the coming years.

Turning to the here-and-now, we all know we live in an inflationary environment, not seen for most of our lives. This environment is impacting the consumer and virtually all industries, including retail. Here at Sprouts, we are encouraged by the fact that our traffic has been relatively stable for several quarters. We've experienced some months where it's up slightly and some where it's down a bit. We're not really experiencing a classic trade down. In fact, many of our higher-priced categories are experiencing the most significant growth.

We continue to experience that our customers put approximately one less item in the basket. That one less item on average is essentially produce, our lowest price point category, the one with the most items in an average basket, and one of our lower-margin categories. Even though we are competitively priced every day in produce, we believe our customer is managing their overall basket spend by eliminating the extra produce item.

How are we managing in this environment? Well, we're laser focused on in-stocks and our merchants and store operations teams are creating key item promotions that produce a buzz in the stores for our team members to support the drive for that extra item. Our merchants also work diligently with our marketing team to develop and test promotions to drive incremental profit dollars. Our teams have done a phenomenal job managing margin dollars during this volatile period of cost increases.

We've also recently announced a partnership with DoorDash. We expect this service to be available in all locations by the end of the year. By partnering with DoorDash, we enter a new marketplace where more customers can access our unique and healthy assortment. DoorDash, along with our long-standing Instacart partnership, should enable ongoing e-commerce growth.

We're working now to get ahead of 2023. We believe the average retail increases this year will produce a tailwind for at least a portion of next year. However, we know it is critical to manage all costs including cost of goods, supply chain and SG&A while progressing in those vital focus areas that I outlined today.

With that, I'd like to turn it over for questions.

QUESTIONS AND ANSWERS

Operator

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

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

This is Michael Lasser for Mark Carden. If the model is evolving from one that was driven heavily by consumers buying produce and other fresh items. And now it's going to be more deli and prepared oriented. How do you think that's going to change the economics over the long term? And do you think that the fact that customers are adding one less produce item into the basket is more of a function of some of the model changes that have occurred? Or is it more of a function of the economic environment right now?

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Yes. I think, Mark -- sorry...

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

It's Michael.

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

Michael. Sorry, Michael. As I think this one through, our produce business is being affected more by the economic environment than by a change in our model. Product remains at the heart and the center of our proposition to the customer, a significant proportion of our sales come in produce. I think what's happening is it's just a little bit easier for the customer to take 1 item out of the basket in produce, they'll buy 1 punnet of strawberries as opposed to 2 punnets of strawberries. And that's certainly a trend that we've seen over the last 2 or 3 quarters.

And with regard to the model, I think it's a customer that's taken us to where we need to go in terms of meals and prepared meals. And we're seeing a strength in that business and the team have done a nice job of developing some great products that fits in with our healthy kind of health and attribute-based assortment. So I think it's more about the evolution of the customer and the evolution of how effective we are coming in our meals space and will become much more effective going forward rather than a significant change in the model, if that kind of answers your question.

Michael Lasser - *UBS Investment Bank, Research Division - MD and Equity Research Analyst of Consumer Hardlines*

Yes. And my follow-up question is you've outlined some parameters around store growth for next year. How should we think about the economic sensitivity overall of Sprouts same-store sales growth in the event there is a recession. You do over-index to more affluent consumers who would presumably be a little less impacted by some of the challenges than other consumers but still your prices are a little bit higher than other retailers. So how do we think about those puts and takes?

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

Well, I think the important thing about our business is our proposition is different to other retailers. So if you're very focused on a vegetarian diet or a vegan diet or keto diet or paleo diet, you're likely to stay that way irrespective of the economic conditions that you're surrounded by. So I think we feel we've got some stickiness in our proposition in terms of what we offer so that irrespective of the context of what's happening in the marketplace, our proposition is differentiated and often appeals to a group of people who very much, I think, are aligned to what we are putting in front of them.

And I think we've seen that from the stickiness in our traffic over the last couple of years. And I've been encouraged by the fact that almost irrespective of the ups and downs around inflation and pricing, we've got a sticky customer, and I think that will continue irrespective of what happens and who knows what's going to happen over the next year or so going forward. We've got a sticky consumer who's bought into who we are. And as we evolve and develop our loyalty and communicate the right engagement with those customers, I think we're well placed to compete almost in whatever circumstances come our way.

Operator

Our next question comes from Ken Goldman with JPMorgan.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Jack, you said last quarter, I believe that e-comm perhaps will settle in at maybe 8%, 10% of sales post pandemic and then grow off that. We're pretty far past hopefully, the bulk of the pandemic now, but your e-com is still growing nearly 20%. It's over 10% of your total, as you mentioned. Why would it, at this point, go back toward a high single-digit number if it's growing so fast in this kind of environment today?

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

Ken, I think that's a really good point. And I think as we've evolved and seen what's happened, our customers have bought into that space. And I think the fact that they're able to access our brand and the branded -- the products that we have that fit in with the health attributes and the kind of diet-focused process. Our customers have clearly voted with their feet around e-commerce and as I said, you're right, I expect it to maybe settle down a little bit more, but it continues to grow. And in support of that one of the reasons we put the DoorDash process in place, which has given more access for people to choose in an omnichannel way how to access our products and our brands. So I think you've appropriately challenged what I said the last time. This thing is continuing to grow, and we expect it possibly to continue to grow further.

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

And then just for a follow-up, I wanted to ask about CapEx. You reduced your CapEx guidance for this year. I know you're not talking about '23, but you have previously provided a range, I think you said 2.5% to 3.5% for next year. Was the CapEx number reduced because it's being pushed into next year? Or were there other factors that went into that for this year?

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

No. It's being reduced just as you get closer and closer to the end of the year, Ken, just -- we're just finding -- we're spending a little bit less on some of the projects that we thought we would spend on. As it relates to next year, we're still looking at probably somewhere between 3% and 3.5% of sales. The store growth will be bigger next year. This is a couple of projects that we'd like to do next year. So we're -- and we have a new DC coming online. So it's going to be closer to 3.5% next year.

Operator

Our next question comes From Rupesh Parikh with Oppenheimer.

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

(inaudible).

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

Rupesh, you are not coming through.

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

Can you hear me now?

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

No. It sounds like you're underwater, I apologize.

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

(inaudible).

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

Sorry, Rupesh, we can't hear you.

Operator

Our next question comes from Chuck Cerankosky with Northcoast Research.

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

A quick question on inflation. What kind of inflation did you see in cost of goods in the third quarter?

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

Yes, Chuck, we don't give out the actual numbers, but you can see it throughout the industry, it's pretty still steady, pretty high inflation has been flowing through for the last several quarters now.

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

Okay. And then looking at the inventory level for going into this fourth quarter, how do you feel about that? How are the other stocks? And how much of a seasonal effect are we looking at for the holiday selling program, realizing that Sprouts isn't as strong in those categories typically as conventional supermarkets.

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

Well, I'd just say, Chuck, we don't sell anything like as much in the seasonal. But January is our big month as we prepare -- as people get focused on their diet specifically going into the holiday period. Generally, we're trying to focus on our stocks, which we talked about and there's a lot of work going on in the stores in terms of working that. We -- very important to us is things like organic turkeys and some of the attribute-based products we've got around vegan and vegetarian for the holidays. We're well placed for that. We feel we're in good shape. Clearly, it's a volatile world that we're living in, but we feel we're in good shape. We've put a pretty good holiday program together. I'm pleased with the marketing we're putting behind the holidays, we're doubling down a little bit on it. So we feel we're pretty well placed going into the holiday, given the context for our business, which you appropriately identified.

Operator

Our next question comes from Spencer Hanus with Wolfe Research.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Could you guys just provide a little bit more context on what's driving the acceleration in your comps in 4Q? And then relative to 3Q, are you expecting a more balanced contribution from units in price next quarter?

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

Spencer, we're not thinking about 3-year comps, and we're so messy. So we're really starting to settle in more on a 2 year. So I could go back and do the math or one of us could. But we really focus on where we are now. As it relates to the acceleration, we're still in this place where we see inflation. We see traffic pretty steady. We see some inflation on cost of goods and subsequent price and with little bit less on the units. And when we came in at the beginning of the year, we're seeing that. We thought that would dissipate in both directions as the year transpired. It didn't happen because inflation was continuing, and it's going to continue now at least through the first half of next year, and then we'll wait and see at that point. But, we're hopeful that as we get through not only will we comp the less units in the basket as we get later into the year, but at the same time, we'll probably lose a little AUR and pick up a little bit on the units.

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

Got it. That's helpful. And then with the pending consolidation in the industry, how do you think that will impact the competitive dynamics in some of your core markets like California, in Arizona? I understand you don't compete directly in a lot of the categories, but just curious how you think that impacts price in the industry?

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

Well, Spencer, it certainly creates a lot of dialogue in the industry that's for sure. I think we're in a position where we do see ourselves and are very differentiated. So we've got a very clear strategy in terms of where we're going forward in terms of our assortment and differentiation. So if consolidation leads to a lot of price investment, it won't be on things that we sell. So we kind of see that we're kind of shielded from almost anything that might happen. So whether it's really successfully mergers or whether they're not successful, we think our destiny is in our own hands, which is not in the destiny of what might happen in the marketplace.

So we're going to carry on plowing our own canoe if that's the right expression. We're going to keep doing what we're doing, developing innovative and differentiated product that fits in with the healthy lifestyle that the customers that we have. And we think that wouldn't be affected by the kind of merger conversations that have been happening in the industry over the last little while and particularly to -- and that would apply anywhere in the country where this operates.

Operator

Our next question comes from Robert Moskow with Credit Suisse.

Robert Bain Moskow - *Crédit Suisse AG, Research Division - Research Analyst*

I understand that Californians are receiving government stimulus checks in October. I want to know if you thought that would be a positive for your business and maybe you could remind us what percent of your business is in California? And then secondly, I wanted to know how much visibility do you have into the 30 new store openings, I mean there's delays in all kinds of projects for all kinds of reasons. And I know you've already pushed back that target once. How solid is the 30?

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

We're feeling pretty solid about the 30 stores. And we've got -- as we've said in the last few calls, we've got a solid pipeline of stores well beyond the number that we need for this year. So 30 is a number that we're feeling comfortable with. And I know this year, we got -- we only got to 16. But we're feeling -- the context of that, we understand much better as we go into 2023 and 2024 than we did in going into 2022 with all the volatility that was going on in supply chain. So all other things being equal, we're feeling good about that number of 30 stores. California is a big part of our business. I don't know Chip, have you got some thoughts on that?

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

It's about 40%, Rob?

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

And in terms of the specifics around -- we don't get as much when people -- when government checks get paid out as other people get, but it certainly won't do us any harm.

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

One thing interesting on that, we don't do as well -- or we don't do as much on EBT in our brick-and-mortar, but we've noticed as we've introduced it on our e-comm platform. We're actually over indexed more than we do in our stores. So it's giving access via e-comm to those customers that we didn't think that would happen, but it's happened.

Operator

Our next question comes from Edward Kelly with Wells Fargo.

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

It seems like the gross margin this year is maybe coming in maybe a little bit better than that sort of like what you talked about. Can you maybe just provide a little bit of color on that? And then as we think about '23, and I know it's early, but can you just kind of talk about what your expectation is there impact of new DC, that type of stuff?

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

Sure. Sure, Ed. For this year, so the quarter, we picked up about 90 basis points. More than half of that was, if you remember last year, in the third quarter, we went out and did a bunch of promotional tests full box, we had promotions on top of promotions and we didn't do that this year as we learned some things out of that. So that's about half of the pickup year-over-year.

If you remember early in this year, we also -- as the merchants have had to deal with the cost increases that have been coming with them, we got a little bit behind. So we had a little bit behind. I think that was either Q4 or Q1 that we were a little behind was Q4. This quarter, we got a teeny bit ahead. So it's as they manage through it net-net, we picked up the 90 basis points. As we think about next year, our aim is to manage our margins essentially flat. We've got a little bit of DC, a teeny bit of headwind there as we relocate our Southern California DC, but there are some opportunities, both in mix and some opportunities to drive a teeny bit of margin. But generally, we're looking at flat for next year.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Okay. And then just a quick follow-up. On SG&A, obviously, with an acceleration in store growth, you'll see an accompanied acceleration in SG&A, but you did sort of mention looking to be sort of like tight on expenses. And I'm just kind of curious what some of the things are that potentially could help you on that line item.

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

Yes. We have some things still in the stores. We're looking at supplies. We're looking at -- I mean, we're looking at every rock to try to make sure that we can manage through that. We have wage increases that are coming at us. But if I looked at the list, supplies is probably a bigger opportunity. We have some things on our tags as we push tags into the store, we're doing less of that. And when price changes, we started that this year. We'll get some more of that next year. And we're just going to have to be tight on incremental headcount or any incremental costs associated with that. Of course, we'll look at marketing, but we want to over-index there, if we can. So it's -- that's the part we just got to manage through. So we'll find ways to make sure that it works.

Operator

Our next question comes from Kelly Bania with BMO.

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

I was wondering if we could just talk a little bit about the new store economic model. I think last quarter, you made some tweaks to that. I was just curious if you could provide an update how you estimate your year 1 new store productivity is coming in? And how many stores do you have that are really tracking towards that year 1 $13 million sales target?

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

Well, we have -- how many we've built in the last -- I mean right now, we're looking at year 1 is $13 million. We're -- we don't know. We don't have that many. We just opened 1 more store this year. We've only got 9 that we've opened this year. So what we're looking at is we still believe we'll be at 16 by year 5, and we'll be relatively breakeven in year 1, and we'll be at 8% EBITDA by year 5. And we're really working hard to manage the cost. So we just haven't put a ton of stores in the ground, and they haven't matured enough for us to reinforce all of those assumptions, but we feel pretty good about it. The one thing we are finding is that more established markets, they come out of the gate stronger where we have brand density and where we don't have brand density takes a little longer. They come in a little bit lighter, and they -- but they build a little faster.

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

And Kelly, I think we've been quite encouraged by some of the stores in year 2, year 3 and some of the less -- in some of the less established marketplaces. We're seeing some strength in some of those stores now, which is very encouraging. So I think the economics of what we're building in terms of smaller stores, we've only got a few on the ground there, but all of them next year will be that and so that we're getting the benefit of that into the economics. And I think we're feeling pretty good about the ramp-up.

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

Okay. And also just wanted to ask about I guess the categories, you talked about deli had prepared as some of the leading categories. And I thought that those were some categories that were maybe a little bit deemphasized in the new store model? Are you rethinking that at all? Are those still -- are those categories still performing well in the smaller stores? Or maybe you could just help us understand really the deli and prepared strategy from here?

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Go ahead.

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

Kelly, then when we started on that track, yes, we were the last prototype that we did, yes, was focused on a lot of the deli area, but we did it in a very grand way. So we made the store bigger. We added a very expensive area for deli, where you could see it being prepared. And those were areas -- it was -- I would call it just excess. We don't need to have that type of elaborate fixturing and that elaborative labor and that much square footage in a given box to be able to be really good at deli. And so we're continuing to evaluate that. But we feel good. We've got good fixtures today. We've got self-serve fixtures today. It's just -- it was just too expensive and too much and yet we can still chase that talk with what we've got in our new prototype.

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

Yes, in the deli space in our V5, which is the version before the one we're working on now, it was very grand, but didn't really add a lot of assortment. And the thing that we've kind of got to over the -- and the pandemic kind of took us there is what an opportunity that as far as prepared meals within that daily environment. So we've added cabinets being down and invested in products and we'll continue to do that. And I think that's come along from the pandemic as much as anything else, what an opportunity there is for us. So we're probably a little bit late to the party, but it's certainly working for us at the moment.

Operator

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

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

This is Kendall Toscano on for Robby. So to start if I could get a little bit more detail on the speed traffic trends. And you said this quarter was more of a steady trend versus the last 2 quarters, you called out hogging traffic. And I think in Q2, you said that there was like a quarter-over-quarter improvement and talk some about the marketing initiatives you're doing and some progress on that. I guess just what's obviously hard in a very inflationary environment. But what are you kind of looking at to measure the progress of marketing and things like that? Would you hope to kind of have like a reacceleration in traffic?

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

Yes. It's Kendall, right? I couldn't quite hear. But Kendall, we've seen last 3 quarters, we had net positive traffic up until Q3, in Q3. And in every one of those quarters, we had some months that were maybe slightly down and slightly up net-net, we were up. This past quarter, we had the same phenomenon, but net-net, we were down just a hair for the quarter in Q3. And then as we rolled into October, October was flat. So it's just -- it's a really steady number. It just moves the teeny bit up and down from a comp perspective. As it relates to marketing, our teams are -- from a promotions perspective, our teams, they're playing with promotions every day -- so every week -- and they measure them and they measure from a traffic perspective, from a sales perspective, and from a profitability perspective. And we're finding, as we've said in the past, some things work a little bit. But we're not -- there's no panacea out there that says this is the perfect thing that we need to do to go drive traffic. So it's just a continuing and then overall marketing message.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

Yes, the marketing spend, I think we'll continue to spend a little bit more money on it. We want to spend more. We want to invest in personalization and loyalty. We're seeing -- we're going to be much more precise with our new media model so that what we spend gets us more returns against that specific kind of dollars. And there -- it continues to be a level of experimentation. We seem to be able to get awareness with our customer. The next challenge for us is getting more engagement. And that's something that we're working on.

And I think this having more, as we've talked in the script, having more e-mails and having more direct ways of communicating with our customer will help us to build that loyalty, build more transactions sometimes from the same customer and sometimes from new customers. And that's very much what we're working on across the space. But as Chip said, there's no panacea here. We made a lot of progress, and I think we're putting some very good building blocks in place to build that loyalty and personalization going forward.

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

That's very helpful. And then just as a quick follow-up. If you could just talk a little bit more about the trends you're seeing with new and existing customers.

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

Well, we've got some very sticky customers, which is why we get a consistent level of part on the traffic that Chip was talking about a little while ago. So in our new markets, the new customers take a little bit -- what we find in our new stores in less established markets on the East Coast and in parts of Florida, is that a lot of customers come in to have a look. And then the real target customers are the ones that stick around and they are the ones that we grow from. So you get an interesting kind of mix when you open a new store, where a lot of people come in and then it takes a little while for that customer to really get who we are because sometimes they come in and think we're a grocery store. And given that we're a specialty grocery store, that changes that dynamic a little bit.

So as I say, we're getting better awareness across the customer base. Our existing customers, how to get them to spend a little bit more. We put a lot -- we've been doing a lot of activity in that space. And new customers we're seeing a balance of both coming into our business.

Operator

Our next question comes from Scott Mushkin with R5 Capital.

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

I guess I'm going to Slide 7, I think you guys put in the presentation where you showed the EBIT margin kind of coming up to about just over 6%. And I know we talked about this in the past, but just kind of taking a step back and looking at the business model and the same-store sales you guys are putting up. Number one, if you -- if they were to stay in this kind of low single-digit range, can you maintain this type of EBIT? So that's kind of the first part of the question, once you answer that, I have a follow-up.

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

Scott, yes, I think we can maintain it. And obviously, with a 10% square footage growth, we're going to need to comp in a place that's probably north of 2 to be able to keep that stable, and we do have some costs that we have to manage through. But net-net, we think that we're in a place where we're certainly not going to see -- we don't believe that we're going to see gross margins deteriorate. We're fundamentally -- we've shifted the business, we've changed the business, it's a different mix in the business today, and we don't see gross margins declining at this point. So it's

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

really a matter of keeping that EBIT margin flat while we're investing in new stores and managing our costs accordingly to be able to ensure that our EBIT margin stays relatively flat.

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

So then the second follow-up question to that is obviously the negative side. The positive side, I get this from clients quite a bit is what can we do more aggressively to get that comp moving higher? And I know you guys are working on some stuff because clearly, it's almost like a coiled spring, the equity itself, if you can get that comp moving higher. I know, again, we've talked about that before, but it's just it comes up with a lot of clients as the stock is pretty cheap if you can get that comp moving.

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

Yes. I certainly agree, Scott, that the stock is cheap. So the opportunity going forward for us is how do we sustainably build a comp and a customer loyalty base going forward. The one thing that we can do is do these pulses of comp by investing margin and thinking that that's going to build long-term sustainable profitable customers. That's how -- that's what the strategy entails slow, confident driving of a customer base who loves what we do and continue -- we get -- continue to get more of the broader trend in the industry is there's a trend towards health and wellness. We're really well placed to take advantage of that. We're really well placed by putting the infrastructure into our business so that we can run it and run it better going forward and efficiently.

A specialty retailer should be operating at significantly increased relative to the conventional industry or significantly increased underlying margin. And that's where we've got this thing too. We now continue to have the opportunity in front of us to build long-term customer loyalty, which builds long-term customer profitability without it being these pulses of in and out and in and out, which have been which certainly are at the direction in which we are going.

Operator

Our next comes from Krisztina Katai with Deutsche Bank.

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

Congrats on a nice quarter. I wanted to follow up on the personalized offers. You currently know about 16% of transactions. It seems like it's a pretty good opportunity. So maybe if you could talk a bit more about some of the metrics you mentioned, I think you said the basket of a loyal shopper is 70% larger. So how are you approaching the analytics side of things to make sure that this customer continues to increase their spend with you and then also get them to come into the store more frequently?

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

Well, first of all, we've invested in a customer analytics team, which we've talked about. So very specifically putting resource into this so that we can mine that data and mine that information about that customer. And try and understand very specifically at a personal level, what that customer what motivates that customer to spend some more money with us. And we've done some very specific tests in areas like Vitamin, specific tests in areas like bulk, specific tests where we can see who is that customer and how do we get a bigger share of their wallet going forward.

We get a pretty small share. Even the customers love us. We get a pretty small share of the dollars simply because of the nature of our proposition. So just mining that data, understanding that data, putting offers in front of them that allows us to grow. We're very early, as I said in the script, we're at the infancy of this whole process, but we've certainly got the infrastructure in place. We're putting the people in place. We're getting some partners on board to help us with this because we're not reinventing the wheel here either. This has been done by a lot of people and a lot of

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

different industries to us. So we see a lot of opportunity in front of us about personalizing offers, driving that loyalty from customers who inherently want to be with us and give us their information. And I think that's going to continue to grow going forward, Krisztina.

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

Great. And then a follow-up. I was wondering if you could maybe talk about some of the tailwinds that you're seeing from the clustering of stores around DCs. Like how has that helped with sales as you are now putting fresher items on the shelves, but also you can quantify maybe just what the tailwind has been on gross margin on distribution efficiency and also cost reduction, especially with the elevated transportation costs that we have in this environment.

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

I'll let Chuck maybe go into more detail. But specifically, if you're driving less distance, and we're so pleased, especially when gas prices were so -- diesel prices were so high. The fact that we're traveling significantly less millions of miles, I can't remember the exact number, 3 million, I'm getting signals here. 3 million miles less on the road to get to the same number of deliveries to the same number of stores is a very significant saving part of offsetting what costs would have come through on there. So that's encouraging. There's some -- going forward, there's going to be some doubling up costs for a little while, while we get our Southern California in place where we need to get it. But long term, that will drive us some efficiency as well going forward. I don't know Chip if you add anything.

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

Krisztina, just the first half of the year, we got some benefits from the less miles and the fact that we were -- we have the new DCs open. Once we got into the back half of the year, we are now in a place where we're comping those benefits. So the back half of the year, it really hasn't been a margin or it wasn't in the third quarter and nor do we expect it be a margin enhancement in the fourth quarter. So really trying to manage that line at this point as a push.

Operator

Our next question comes from Rupesh Parikh with Oppenheimer.

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

Hopefully, you can hear me now.

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

We can hear you, Rupesh.

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

Okay. Great. So just on the new store prototype, I believe the one outside of -- or in Phoenix -- outside Phoenix, now here in year 2. So just curious how that store is performing. And just overall, as you continue to roll out the new store prototype. Any surprises, positive or negative?

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

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

It's very close to being a year. I'm trying to look at Chip whether that site overlapped a year. Yes, it has just overlapped. We're encouraged by the underlying numbers in that store. It's coming through well relative to where we would have expected it to be and we're very confident on the returns on that. The other stores that we've opened, and it's only a handful are coming through pretty well across the board. So we're encouraged by that at this stage. And the economics are better than they would have been significantly because we're paying less rent, the operating costs are lower.

And in the context of going forward, I'm glad that we're building smaller stores because there's a lot of potential costs going the other way in terms of construction they're having to manage. And we're very -- we're encouraged to the fact that we're building smaller stores in terms of making that economics work. And the mix in the business, it's coming through kind of the way we expected it to a little bit -- a little bit of strength in the deli business, which may be surprised us a bit. That's come through well. And frozen foods has been very encouraging in terms of what's happened in those new stores, which I think we can double down on going forward.

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

Great. And then maybe one quick follow-up question for Chip. Just as we look at Q4, is there any more color you can provide in the interplay of gross and SG&A margins for the quarter?

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

Yes. I mean Q4, we're sort of expecting margins to be in the 36% range. And I suspect cost will probably rise year-over-year on the SG&A line, call it 7-ish percent, and that's -- we said we'd comp around 2.

Operator

And I'm not showing any further questions at this time. I'd like to turn the call back over to Jack Sinclair, CEO, for any closing remarks.

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

Well, thank you, everybody, for your attention today. We appreciate your interest in our business, and I wish you all a very good holiday season. Thanks a lot.

Operator

Ladies and gentlemen, this does conclude today's presentation. You may now disconnect, and have a wonderful day.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

REFINITIV

DISCLAIMER

Refinitiv reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES REFINITIV OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2022, Refinitiv. All Rights Reserved.

©2022 Refinitiv. All rights reserved. Republication or redistribution of Refinitiv content, including by framing or similar means, is prohibited without the prior written consent of Refinitiv. 'Refinitiv' and the Refinitiv logo are registered trademarks of Refinitiv and its affiliated companies.

