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SFM.OQ - Q1 2023 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: MAY 01, 2023 / 9:00PM GMT

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## PRESENTATION

### Operator

Good afternoon, and thank you for standing by. Welcome to the First Quarter 2023 Earnings Conference Call. (Operator Instructions) Please be advised that today's conference is being recorded.

I would now like to hand the conference over to your speaker today, Susannah Livingston, Vice President, Investor Relations and Treasurer. Please go ahead.

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

Thank you, and good afternoon, everyone. We are pleased you are taking the time to join Sprouts on our First Quarter 2023 Earnings Call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Chief Financial Officer, are with me today. The earnings release announcing our first quarter 2023 results, the webcast of this call and quarterly slides can be accessed through the Investor Relations section of our website at [investors.sprouts.com](https://investors.sprouts.com).

During this call, management may make certain forward-looking statements including statements regarding our expectations for 2023 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.

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

Thanks, Susannah, and good afternoon, everyone. I want to begin our call by thanking our 31,000 team members for their continued dedication in creating a best-in-class experience for our customers seeking fresh, high-quality and healthy foods.

We are pleased with our first quarter. We believe our long-term growth strategy is gaining traction and driving positive performance. Our results included comparable store sales growth of 3.1%, total sales growth of 6%, and adjusted diluted earnings per share growth of 24%. Our traffic trends are improving, and our newer stores on average are exceeding our internal expectations.

During the first quarter, we opened 8 new stores, grew our Innovative and Sprouts Brand offerings, improved our marketing spend, enhanced our supply chain and developed positive programs for the environment. I'll follow up with more on our journey in just a bit.

For now, let me hand it over to Chip to review our financial performance in the first quarter and our 2023 outlook. Chip?

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

Thanks, Jack, and good afternoon, everyone. For the first quarter, total sales were \$1.7 billion, up \$92 million or 6% from the same period in 2022. New stores, combined with comparable store sales growth of 3.1%, drove this increase. Comp sales were supported by positive comp transactions or traffic, and a net increase in basket due to retail inflation, partially offset by a slight decrease in items in the basket from a year-over-year perspective. We are especially pleased with our e-commerce sales, which grew double digits and represented 12.2% of our total sales for the quarter.

We are also encouraged by the positive trends in our newer markets as we densify and create more brand awareness. And as Jack already pointed out, we are pleased that our new stores on average are exceeding our expectations. We continue to experience strong performances in categories with the most differentiation, such as grocery, bakery, dairy and deli. Our Sprouts Brand, now at 20% of total sales, performed well as customers continue to seek uniqueness and quality.

Our first quarter gross margin was 37.5%, an increase of approximately 20 basis points compared to last year. Category mix shifts and continued promotional optimization contributed to the margin improvement. SG&A for the quarter totaled \$486 million. Excluding the impact of special items, adjusted SG&A totaled \$483 million, an increase of \$23 million. This increase was primarily driven by the addition of new stores, higher wages, utility costs and higher e-commerce fees, partially offset by approximately \$4 million shifted to the back half of the year.

Store closure and other costs totalled approximately \$28 million for the quarter and were primarily related to the charges associated with the decision to close 11 stores in 2023. Excluding the impact of special items, adjusted store closure and other costs were immaterial.

Depreciation and amortization, exclusive of depreciation included in cost of sales, was \$34 million for the quarter. Excluding special items associated with the store closing decision, the adjusted depreciation and amortization totalled \$30 million.

For the quarter, our earnings before interest and taxes were \$102 million and interest expense was \$2 million. Net income was \$76 million. Diluted earnings per share were \$0.73. Excluding the impact of special items, adjusted earnings before interest and taxes were \$137 million, adjusted net income was \$103 million, and adjusted diluted earnings per share were \$0.98, an increase of 24% compared to the same [quarter] (corrected by company after the call) in the prior year.

Now let's turn to the balance sheet and cash flow highlights. Sprouts has always had robust cash flow generation and a strong balance sheet. During the first quarter, our cash generation allowed us to invest in our business by opening 8 new stores, purchasing the 2 previously licensed stores, spending \$45 million in capital expenditures, net of landlord reimbursements, paying down \$25 million of our bank revolver and returning \$98 million to our owners by repurchasing 3 million shares.

We ended the first quarter with \$295 million in cash and cash equivalents, \$225 million outstanding on our \$700 million revolver and \$22 million of outstanding letters of credit.

Turning to our current expectations for 2023. The consumer environment remains uncertain. However, we remain committed to our business strategy, which we believe can continue to deliver ongoing profitable growth. For the full year, we expect sales growth of 5% to 6% and comp sales growth of 2% to 3%.

We expect gross margins to be flat to slightly up and slight deleverage in SG&A. The deleverage is due to the acceleration of new store growth, a new fee structure with our largest e-commerce partner and rising labor costs.

We expect adjusted earnings before interest and taxes to be between \$370 million and \$385 million. Adjusted earnings per share should be between \$2.58 and \$2.68, which assumes no additional share repurchases. That said, we do expect to continue to repurchase shares opportunistically.

We are on track to open at least 30 new stores this year, all of which are in our current prototype. And we expect capital expenditures, net of landlord reimbursements, to be between \$210 million and \$230 million.

For the second quarter of the year, we expect comp sales of approximately 3% and adjusted earnings per share between \$0.61 and \$0.65.

And with that, I'll turn it back to Jack.

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

Thanks, Chip. We're encouraged by our most recent performance, a direct result of the strategic changes we've made over the past few years to differentiate ourselves as a specialty health and food retailer. We believe these changes are gaining traction now that we're on the other side of the pandemic. This year, we're focused on expanding category leadership, creating a unique assortment, focusing on product innovation, building a more efficient and effective supply chain, accelerating our store unit growth and growing customer engagement. Let me touch on a few highlights from each of these initiatives.

For the first quarter, our focus on curation and innovation is inspiring our customers. We stocked ourselves with innovative attribute-friendly specialty products which appealed to our target customers. We are building a strong affinity for our Sprouts Brand, including many products only available at key seasonal times. Our customers recognize that the Sprouts Brand provides quality offerings that taste great and are good for you.

Amid the high inflationary environment, we brought in more value forward offerings like multipack grocery items and value-sized meat and daily offerings while continuing to offer great pricing in our produce department and on important items such as our Sprouts Brand, cage-free eggs at \$3.99 and our healthy sandwiches at \$4.99.

Moving on. We continue to improve the efficiency of our supply chain, touching both in-store and distribution centers. Categories with perpetual inventory computer-assisted ordering, PICA0, are already experiencing better on-shelf in-stocks. Most categories will be completed this second quarter, removing the guess work from our inventory process.

Our investment in the new Southern California DC is on target to open later this month. Not only will the new DC support our growing capacity needs and be in a more robust labor market, but it will also be LEED Silver certified, contain solar on the roof, reduce miles on the road and carry an electrified jockey truck to ensure our sustainability efforts reach the DCs.

In the first half of this year, we will complete the addition of ripening rooms in our Arizona, Texas and Southern California DCs, along with expanding our Texas DC later in the year. These initiatives will expand our capabilities, improve our quality and freshness and leverage our supply chain to support our future unit growth.

Speaking of unit growth. Our smaller, more cost-effective format is rolling out quickly this year. We opened 8 new stores in the first quarter. All of this year's stores will be in the new prototype. At the same time, we're experiencing an improved performance with our more recent vintages, especially in newer markets, where we're gaining density and growing brand awareness. Our pipeline is also growing with 90 approved new stores and 60 executed leases, helping us gain traction towards our goal of 10% unit growth per year. We believe we will be on track to achieve that goal by 2024.

During the first quarter, we also purchased 2 previously licensed stores in Chula Vista, California. These 2 stores were part of a unique legacy licensing agreement. The purchase provides complete control of the Sprouts Brand and expansion opportunities in portions of the San Diego market that were previously restricted by the agreement.

Over 60% of our business is driven by our high-frequency customers. Our goal is to drive our current core customers to shop more often and to encourage trials from new customers who are also within our target audience. We will drive this growth through customer engagement.

First, we're driving customer engagement in our stores as a foundational focus. We're elevating the level of service in our stores to meet the needs of our customers and distinguish ourselves from the competition. The team is focused on ramping up our sampling program, particularly with our unique Sprouts Brand offerings, increasing speed at checkout and proactively helping our customers navigate the store while finding products that align with their dietary needs. Our customer survey scores, already strong, continue to rise.

Our second area of customer engagement has been expanding and improving Sprouts' unique omnichannel experience. The flexibility of ordering online and picking up or having the Sprouts favorites delivered provides a much desired option for our core audience. Our e-commerce growth continues to outpace our overall growth, signaling that our differentiated products resonate with customers. We recently improved our site design and digital experience to improve conversion and sales. Our own site, [shop.sprouts.com](https://shop.sprouts.com), and our Instacart and DoorDash partnerships continue to support our current customers' needs while also bringing in new customers. Our e-commerce sales represented 12.2% of our total sales for the first quarter.

Our third area of customer engagement is targeting our core audience with data-driven media. We've improved the return on investment on our media spend with a more targeted driven approach to our media mix, leveraging our first-party data and consumer insights to identify our customers better.

In many markets, we are still relatively new, so we're driving awareness with more storytelling about the brand, speaking to our local produce and presenting offers for trial. In turn, our awareness numbers have improved in markets like Florida. We have seen higher returns in our established markets by driving consideration and reminders to visit our stores.

Finally, we are deeply focused on our personalization strategy and are still in the early innings. Our customers are discerning in what they eat, and our ability to know them, share content with them, and provide offers for what they love is driving spend.

In Q1, we improved our speed and capability and outperformed our expectations. As I have noted, this is a longer journey, but we are committed to building capability, and our customer is responding.

Lastly, our ESG efforts continue to develop and grow. Central to our identity is a genuine commitment to social and environmental responsibility. We work collaboratively with our supply chain partners, community organizations, and industry experts to understand our material impacts and prioritize where we direct our environmental, social and governance efforts.

In 2022, some of our highlights included: Nearly 26% of total sales came from organic products, approximately \$200 million in sales of products produced by diverse owned suppliers. We sold \$145 million in local produce, less carbon-intensive plant-based product sales increased 21%. We recovered 87% of food waste and we donated the equivalent of 27 million meals. We also recycled more than 800,000 pounds of plastic from customer return bags and product shipping wrap. And this year, we have already launched new programs to better serve our customers, our communities and the environment: rescued organics in California and the launch of our elimination of single-use bags at checkout. Based on our ESG accomplishments, Sprouts was named 1 of the 100 most sustainable companies in the world by Corporate Knights.

Better eating and healthy eating is not a trend. It's a fast-growing movement of customers seeking a healthier lifestyle, even during challenging economic conditions. Given our leadership in being a destination for health, wellness and innovation, Sprouts is well positioned to grow. Our commitment to our strategic changes is beginning to show results, attracting more customers and visits and doing so profitably.

I look forward to speaking with many of you in the coming months. And with that, I'd like to turn it over to the operator for questions. Operator?

## QUESTIONS AND ANSWERS

### Operator

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

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

So to start, your 3.1% comp came in meaningfully above your guidance, the highest level you've seen since 2020. Within that, where were the biggest differences relative to your initial expectations? Did traffic accelerate more than expected? You called out the slight decrease in units per basket, but is that starting to stabilize a bit faster than you expected? Or is it really something else driving it in the back half of the period?

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

Mark, this is Chip. It's -- generally, it's traffic. The AUR and the units are in line with what we thought. We had slightly better traffic in Q1 than we thought we were going to have at the beginning of the year.

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

Okay. Great. And then just in terms of you talked about your new stores exceeding expectations. Now that you guys have had a few quarters or even building the new prototype -- are you noticing any consistent differences in how customers are shopping these stores from a mix perspective relative to your legacy boxes?

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

Well, we've been encouraged by the new -- first of all, we're encouraged by the benefits of getting by having smaller stores in terms of the cost of the stores and the returns that they come. But in terms of how customers are shopping them. I think post pandemic, we've seen an encouraging number in our vitamins and supplements department, where people with the idea of immunity, people get more kind of focused on immunity post pandemic. And I think our stores have done a nice job at kind of capturing that.

We've been encouraged by the bounce back in our bulk business, which took a bit of a hit through the pandemic through lots of operational challenges within different jurisdictions, even not being allowed to sell it. So that's worked quite well for us.

And the work that we've put in on 2 significant things in the store. One is the meals case. We've been adding a lot of ready meals cases with meals that are targeted towards health and plant-based and a little bit differentiated. So we're encouraged by that investment. And we've also invested a lot of time and energy putting an innovation center into most of our stores where you'll find a range of products that rotates every month, but every single product, you won't be able to find anywhere else.

So the differentiation that comes from that innovation. So we've seen those kind of spaces. So meals, innovation, vitamins, bulk, we've been encouraged by that and underpinning all our grocery and dairy businesses, and our frozen business have been bouncing pretty well -- have been doing well. We invested quite a lot of space in frozen in our newer stores, and so we're encouraged by that -- those returns as well.

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**Operator**

(Operator Instructions) The next question comes from Ken Goldman with JPMorgan.

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

I just wanted to get a quick sense of what you're seeing from the competitive environment. It doesn't seem like there is a significant amount of pricing pressure or intensification of promotions out there. We're certainly heading in that direction, but it doesn't feel like there's anything dramatic yet. But I'm just curious what you're seeing and what you're hearing out there, and if there's anything that you're more or less concerned by than what you might have expected a few months ago.

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

Yes, Ken. We kind of haven't seen -- as you say, we're not seeing a lot of dynamic changes in terms of how people are positioning their pricing. We're certainly not seeing anything from any of the major players in this going forward. But as I've kind of always said on these calls. We kind of watch produce a lot in a lot of detail. We haven't seen much in that.

The other assortment, the range of assortment that we have, is pretty differentiated from the others. So we kind of -- yes, we watch what other people are doing. The piece that we watch most is produce, the other side of the equation. I haven't seen much. But even if we did, we feel as if we've got a pretty -- we've got a strong moat in the assortment that we have and the differentiation that we have, that almost whatever happens going forward, we feel confident that the way we're building our assortment and curating differentiation, that we can withstand what might happen or what might not happen in the pricing environment going forward.

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

And then a quick follow-up. Speaking of produce. Obviously, there's been a lot of rain in California, in some locations, too much. I'm just curious what your forecast is for supply as a general rule in summer or whether you -- and whether you expect it to maybe be a net tailwind or a headwind to your top and bottom line. It might be too early, but I'm just trying to get a sense of how you view that.

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

Well, actually we see a lot of volatility in this going forward. And it has been quite tight over the last few months. There's been some challenges, both in terms of weather and some of the challenges of getting the crops out of the ground. So there has been some issues in terms of making that work.

I think we're feeling more confident than less confident going forward on produce sourcing. We think there will be some ups and downs depending on how it all plays out. But I think, if anything, we're feeling more confident rather than less confident about being able to access the products that we want to prove quite hard on trying to source more and more organic products, and I think that's something that will play well to our customers. And we think we'll probably be in a good shape through the summer to work that one through.

And we're also working pretty hard more than ever on local sourcing. So as we've opened our Orlando distribution center, Florida, when it hits the season later in the year, will be in good shape for us. And so I think we're probably more positive than less positive about the supply challenges going forward.

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**Operator**

(Operator Instructions) The next question comes from Edward Kelly with Wells Fargo.

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

I wanted to ask about your expectation for inflation as the year progresses. I mean, it does certainly look like the pricing aspect is easing quite a bit. Kind of curious as to what's in your guidance for that?

And then how do you think consumer behavior, your own traffic items in the basket, things like that change as the year progresses. I think there's concern that as it slows, right, that hurts the comp, but I don't think that that's how you necessarily see it in the guidance. So just curious as to what the rest of us are missing, for those that are worried about that.

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

Well, let me do some macro comments, and I'll pass on to Chip to do some of the specifics in the middle of this.

I think the context of food inflation has been quite unusual in the last year and that there's a lot of macro factors, particularly the kind of availability of fertilizer and bringing them, some of the pressures that have come from the Ukraine-Russia situation. I'm not sure that's going to go away, and the volatility that's come from that is certainly flowing through in terms of different commodities across the marketplace.

Our forecast going forward is that it will -- clearly, we're not going to double down. It's not going to carry on at the rate that's going to carry on at. But we're certainly not expecting any deflation going forward as the year goes on within the forecast that we've put in place.

With regard to the basket, I'll pass you on to Chip.

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

Yes, Ed. So we kind of always thought, from the beginning of the year that our traffic would be relatively flat for the year. We assume that we would continue to get AUR benefits from inflation, as it's continued to -- all those changes that happened last year all the way up through the end of last year, and in some cases, continuing, that, that would flow through, but start to dissipate from a year-over-year perspective, and more stabilization sequentially.

And then as it relates to units in the basket, similar, but just the opposite, units have been down year-over-year. But as you start to get through the year, you start to see the sequential decline stabilize, and therefore, your comp net-net comes up about where we guided. And it's a mix of, call it, less traffic with less benefit from AUR and a little less worse hit from units.

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

Great. And then just a follow-up one on SG&A. You talked about slight deleverage. You [deleverage] a bit this quarter. It seems like maybe that deleverage is more back-half weighted. Maybe could you talk about that. I know there's a new e-com fee structure. I'm not sure the magnitude of that either.

And then just the last part of all this is that you haven't had any EPS adjustments for the last couple of years. I'm curious as to what we're seeing this quarter. Do you expect more adjustments going forward? Or is this kind of like one and done around the store closures?

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

Yes. So as it relates to SG&A, SG&A as we migrate through the year, there will be some deleverage in the back half as you sort of through. It's driven by 3 things: one is the acceleration to store growth. The second is the e-commerce fees, as you mentioned because as we got out of our exclusive contract that structure changed, which was a decision that we made.

And then thirdly is labor costs on the stores specifically. Last year, we thought the cost per labor hour increases in the beginning of the year, not really what we wanted to do, but it was hard to staff the stores. But beginning in the second half of last year, we were able to find some efficiencies via a lot of the systems we've been implementing over the years. And we were able to take some hours out of the stores.

So that's running through until the first half this year, but then you start to get in the back half and those efficiencies will now have been anniversaried. So we'll get some slight deleverage in the back half of the year. And net-net, will be slightly negative for the year.

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

And just on the one-timers, just curious if you like...

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

Yes. So the one-timers, we'll still have a little bit going forward. So most of it is behind us as it relates to store closings. But net-net, we approximated around \$45 million for the full year, all in. We just did \$35 million, so we got about \$10 million to go. Some of that will be in supply chain costs. As it relates to the San Diego or the Southern California DC, some transition costs there. And there's a little bit more on the store closings really around severance.

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**Operator**

(Operator Instructions) The next question comes from Michael Montani with Evercore.

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**Michael David Montani** - *Evercore ISI Institutional Equities, Research Division - MD*

I just wanted to ask to start off, if you could discuss a little bit more the health of the consumer and particularly what you found in terms of the mix impact as well as any kind of geographic color that you can share of how comps were in the quarter by region.

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

Yes, Michael, we've seen a pretty consistent pattern across the country on this. There's some difference in terms of the speed at which some of our stores in the less developed market. But overall, the consumer behavior has probably been pretty consistent across the country.

Certainly, there's pressure on the consumer. The 1 thing we've always said about our business is that, when you have a differentiated food assortment, the people that are interested in vegetarians or ketos or paleo specific diets, tend to be kind of resilient to that irrespective of the economic circumstances of our base. So we've seen a bit of a consistency in how consumers have reacted to the categories where we've got very significant differentiation.

And that's been part of the strategy all along, which is how do we curate differently. But the behavior we've seen has been consistent across the country, and we've seen strength in those areas where we're differentiated. And that's given us some encouragement that the strategy we've put in place is strong.

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

And I would add, Michael. So Michael, I would add. We saw some -- California, which is a big -- huge market for us. California is really strong. Florida is really strong, where we put a lot of new stores in. So that area, as the stores are starting to comp. That's been really good for us holistically. In Arizona, which is our home market, has been solid.

So net-net, we've had a couple strong, but I think some of that is not really consumer-driven. As Jack mentioned, where it's not really -- one consumer is different than the other. I think some of it is just where we have strength and we're starting to monetize it.

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**Michael David Montani** - *Evercore ISI Institutional Equities, Research Division - MD*

And just to follow up on the cost side. I think you may have mentioned a \$4 million shift in SG&A into year-end. So I just wanted to understand that as well as the impairment cost of around \$30 million. Was there any store operating expense in that? Or was that strictly closure related?

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

That was closure related, There's some depreciation in that total number, so it should be totally outlined for you in our release. So we have that. And I apologize, Michael, what's the first part?

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**Michael David Montani** - *Evercore ISI Institutional Equities, Research Division - MD*

You may have mentioned a \$4 million shift in SG&A.

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

The \$4 million shift yes. So we have some initiatives -- internal initiatives that really are kind of shifting to the third quarter that we thought we would get done in the first quarter. So those are just a shift in some costs.

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**Operator**

(Operator Instructions) The next question comes from Rupesh Parikh with Oppenheimer.

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

Just going back to your commentary on e-commerce growth, you guys called out strong double-digit growth. And I know you are also lapping Omicron compares to a very strong growth number. Just curious on the sustainability of the momentum there.

And then I know you added DoorDash, just curious how incrementality has played out as you've added another provider there.

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

Well, we've been pleased, Rupesh, with the DoorDash. The launch of the DoorDash customers seem to have reacted well to and it seems to have brought some new customers to our platform. The way we're thinking about e-com is very much on an omnichannel basis that the customer will choose how they want to transact with Sprouts.

The thing that's encouraged us about the e-commerce growth is that in a grocery environment is relatively easy for people to buy from whomever they feel like. And the fact that they can only get the assortment from Sprouts, that we sell, gives me some confidence that customers are navigating their way to our curated assortment in a very positive way.

And the context of -- we're very pleased with the work we do with both Instacart and DoorDash, and customers can choose how best to access e-com. At the same time, our pickup business has grown as well over the period of time and our in-store traffic is going up a little bit. So we're getting a nice balance across the 3, but our e-commerce business has been very strong over the course of the last year, and we're encouraged by it.

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

Great. And then 1 question just on traffic. So if you look at your initiatives, is there anything you can point to in terms of what's driving that positive traffic? And then I've been in stores and I've seen some sampling and the in-store experience has clearly improved. So just curious if there's anything you'd point to in getting to...

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

I mean, the big bucket. I think the media work has been more effective than it had been. I think we're communicating a little bit more effectively with our target customers than we were. So I'm encouraged by that.

I'm encouraged by the in-store work that you referenced. The fact that we're going to get I think post -- the pandemic kind of took the wind out the sales of creating the sampling environment for innovative product in the store, and we're having to reinvent that a little bit, and the teams are doing a lot of work on that and making a lot of progress, trying to make that come alive.

So the combination of media and in-store execution, I think, is contributing to that.

And increasingly, tactically, we're testing a lot of different things to be more personalized in how we communicate with our customers. And we think we're getting some benefits of that. But we're really in the early innings of that one. And I'm pretty -- I'm quite excited about the future on that and what we can do as we get better and better identifying the target customers.

We're up to 18% of our customers giving us their information now, which we didn't have before. And that's something that will -- such an upside as we grow that going forward. So it gives us a lot of runway going forward in these initiatives.

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**Operator**

(Operator Instructions) The next question comes from Krisztina Katai with Deutsche Bank.

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

Congratulations on a great quarter. I wanted to -- Jack, just wanted to follow up on the personalization, especially because it sounds very exciting. But as we think about the effect of inflation on Sprouts with the items for basket decreasing by those 1 or 2 units, do you see the moderation in inflation, especially in fresh food, as an opportunity to really start to add those items back? And this is where I think personalization comes in. And I know it's early days, but are you finding success to drive those more frequent trips and with more items per basket with your targeted consumer?

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

We're making some progress on trying to figure out exactly how to do that more effectively. Inflation has clearly led to volume drops across the industry, and we're seeing that across our basket, as we've talked about over the last few calls. What tends to happen, and we've seen it in category by category. When the inflation comes down a little bit, the level of unit reduction changes a little bit. So the level of reduction changes a bit. And that balances itself out, and we've seen that in a couple of categories over the course of the last little while.

The key to the personalization question that you're asking, Krisztina, is how do we target more specifically? And very specifically to that the sampling program in stores, we're seeing very good results on a category by -- product-by-product basis when we get those products in front of people. We've been very encouraged by that, and we'll see that. We're doubling down on that over the next little while. Will be important in trying to increase the number of units per basket. And we do think the mitigation inflation and the execution inside the stores will help us drive that. On top of that, the personalization communication with these additional customers that we've got, giving us information, will allow us to promote more directly, and that will be a key factor.

The business is focusing on 2 things. One, how do we get more transactions into the stores? And secondly, how do we drive the basket in terms of when we get people into the stores or on to the e-com system?

And Chip, do you want to add something?

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

Yes. I just would add to our expectations, Krisztina, as inflation dissipates, we're not assuming for now that you'll see a massive reversal in units in the basket. We'll just see a similar stabilization. So all the things that Jack's talking about are opportunities to drive better results than what we're assuming today.

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

Great. And then just a follow-up. I mean, it does sound like industry promotions remain very rational, but now that the supply chain is in a much better place, large peers seem to be back to their historical and stock and service levels, and trade spend is starting to return, especially in center of store. And I know that your overlap is relatively limited, but does that change at all the way that you view your price gap currently?

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

Well, I think we constantly -- as I said earlier, we constantly look at what other people are doing, We feel as if a lot of categories, we've got real differentiation. A lot of people don't sell a lot of vitamins and supplements. We're not seeing that category under pressure. Bulk gives us a huge opportunity in a tough environment that not a lot of people get involved in. Our proportion of sales in plant-based and keto and paleo, it's just very different to what other people have.

So we don't look at that and we don't see the context of a big grocery price war really directly if that ever -- I don't think it will happen, but if it did happen, we don't see that significantly affecting our major categories that we have. As I said earlier, we constantly look at produce pricing, and that's something we'll pay a lot of attention to going forward. But we're certainly feeling that the margin growth that we've had will -- we will be able to maintain that going forward in the context of what might happen or what might not happen in a grocery environment -- in a competitive grocery environment.

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**Operator**

(Operator Instructions) The next question comes from Leah Jordan with Goldman Sachs.

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**Leah Dianne Jordan** - *Goldman Sachs Group, Inc., Research Division - Research Analyst*

First, I wanted to ask about produce. How are you thinking about your price gaps in that category specifically? And has there been any change to kind of the strategy of around 10% to 15% below traditional?

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

Well, you've got a lot of context to that question. Leah. It's a good question, it's something that's at the core of our we think a lot about it. So different competitors are approaching have always approached produce in a different way, and we've got even bigger gaps than that against some people in the marketplace, and we've got smaller gaps against other people in the marketplace. We tend to find the Texas market is more competitive than some other markets. The Florida market, less competitive. The California market, less competitive.

Our focus, again, we're trying to be very aggressive on organic pricing. So you would find that organic produce, which is a much bigger proportion of our sales than anyone else's sales in the produce space, we've got bigger and wider gaps than what you just alluded to in your question, Leah.

So I'm a bit narrower on more commoditized products. But we think that's a space that we can win. As other people margin up on organic, we're trying to be more flatter on those margins. So we've got opportunity to be really differentiated on price and organic. So we've got opportunities across the marketplace where we're less competitive, some places more competitive.

But everywhere, we would aspire to be, on average, given all the volatility, at the best point in the marketplace. Some places, we're much, much better than just being the best.

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**Operator**

(Operator Instructions) The next question comes from Karen Short with Credit Suisse.

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**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

Just a couple of questions. So when you look at the charges that you took this quarter for the closed stores, can you maybe kind of try to give us some color? Because the dollar amount per store seems very high. So that's my first question.

And then my second question is just looking forward on actual new store productivity, how we should think about that going forward as a percent -- but the dollar amount on the closure is kind of more -- just...

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

It's in line with what we guided to is -- Karen, it's in line with what we guided to at the beginning of the year. So we took \$20 million in store closure and other costs this quarter. We also had \$4 million in depreciation. And then we had some SG&A costs. It's a couple of million dollars spend that we have \$35 million.

When you're closing the stores, you're having to take the entire asset cost and write the asset down, net of any sort of landlord, any sort of subleasing. So if you have a store that's got years left on its lease, it's not just we closed some stores. They weren't all old stores that we closed, they still had years left on their leases. And so that asset is going to get written down quite a bit when you think about a store that may be still has 7 or 8 years left on its lease.

**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. But to be clear, so going forward, there should be no more store closures. These were like...

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

There shouldn't be going forward. We should -- in the second quarter, you're going to see a little bit of one-offs in supply chain, which is up in cost of goods, a couple of million dollars. In the second quarter, you'll see a little bit of SG&A. And then you'll see on the store closure line, you'll see -- you won't see anything on the store closure line going forward.

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**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then so going forward, as you open stores, what would be the right way to think about new store productivity in general?

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

It's creeping up. And we don't have -- I mean, we have a target that we gave you an algorithm as it relates to a new store from year 0 to year 5. But as you can see in the math, it differently, our math is increased, it's getting better, around 75% or better.

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**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

So as we model it, and again, I get it, like it's timing and it depends on when in the quarter. But if I'm modeling it, I should look at new store productivity at like 75%. Is that fair?

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

Yes. If you model -- if you're going back -- if you try to get out of the algorithm, the algorithm really hasn't changed the way we've assumed it. You're going to come out at \$13 million on average, it's going to cost you \$3.8 million to get in. That's 75% of maturity. And you're going to see kind of take about breakeven in year 1. And it's going to be, by year 4, will be 30% to 35% year-on-year cash returns.

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**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. So nothing changed on the algo, generally.

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

No, nothing's really changed. I mean, we're -- I mean, it's really early. We just opened stores that we opened later last year, were opened this year. We're encouraged because they're coming out of the gates better than -- on average than we thought they were going to come out of the gate. And they performed. We're talking about stores that are anywhere from -- they're not even a year old yet. So we're encouraged that we are doing better than what we thought when we modeled them, but their time will tell.

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

And Karen, we're kind of encouraged that new stores are opening a little bit. And I think post -- I think it's hard during the pandemic to open stores and get huge numbers straight away as customers were less reluctant to try new things. We're definitely seeing a strength in the latest stores that

we've opened, the last dozen or so stores that we've opened, as the pandemic starts to kind of unwind. So we're encouraged by that, against the numbers that Chip is talking about.

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**Karen Fiona Short** - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. Jack, if you don't mind me asking just a quick question. So obviously, those -- the new format is very different, right? You only have 1 entrance. Like your focused on ROIC on the stores. But is there any inclination to change what the new format looks like as it relates to balancing ROIC relative to sales? Because -- I totally understand what you're doing in terms of ROIC, but...

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

Well, the principle behind what we did those few years ago, was that we would hold the same absolute level of sales on much smaller stores, which gives you a much better return. The intent wasn't to just to get ROIC up. The intent was, can we give the proposition to the customer that is effective in a 23,000 square foot store as it is in a 30,000 square foot. During my observations, and I think we talked about this, my observations were there's a lot of empty space and there's a lot of space in the noncustomer-facing part of the store that we can squeeze, that allow us to get the same assortment in place at the same time as at -- the same assortment and get the same kind of sales on a much smaller cost base.

And by and large, that's the kind of path that we're on around the numbers going forward. We are certainly tweaking things. I'm really pleased we did 1 door to be honest with you, because vitamins and supplements on 1 side, get in control of that. And everyone knows about what's happening and the challenges of selling things from a crime point of view. We're very pleased by that in terms of how that's working for us.

So we're out tweaking a few things we're we've got our lines. We're looking at how we're handling our bakery. We're looking at where we should have our meals fixer. So we're tweaking things. But the basic principle of what we're operating to, we're very encouraged by.

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**Operator**

(Operator Instructions) The next question comes from Chuck Cerankosky with Northcoast Research.

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

Jack and Chip, could you give us an idea of what inflation was through the first quarter and where you think it will be at year-end? And then how that might be reflected in volume.

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

Well, the first quarter is still tiering on double digits. We expect, by the end of the year, that will be, from a year-over-year perspective, will be significantly lower than that. But at the same time, the units per basket not -- as I said earlier, we're not expecting a reverse in units per basket. We're expecting sequentially that they will stabilize. And as they do, then you have -- instead of having a, call it, high singles loss on units, you're down in the low singles year-over-year while sequentially you're flat.

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

When you say single, you're talking about percentage changes?

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

Yes, sir. Yes, sir.

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

Percentage change. Now apart from inflation, are you able to discern from your customers, whether they have whether it's economic anxiety that's affecting the basket size, number of units in the basket because it sounds like you're making great progress in delivering value with bulk and the private label items and the value packs in things like the meat department.

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

So we've talked about this a little bit, Chuck. Our produce business is seeing a little bit of a reduction. And we think -- part of this is we think people managing shrink at home. Rather than buying 2 packs of salad, you'll buy 1 packet of salad so you don't run out of it at home. And that's 1 of the things that I think people are paying a lot more attention to.

And that's a trend that we've certainly seen in our business where units are coming down a little bit in our produce space. You only need to buy 1 strawberry rather than 2 punnets of strawberries. And that would be 1 of the biggest drivers to the numbers in terms of how customers are reacting to it.

Across the other part of the store, we're seeing some -- as you said, we're seeing some -- we're encouraged by some of the numbers that we're seeing there, which again ties up with this kind of, if you've got specifically that specific dietary needs or specific interests in certain attributes, you tend to not compromise yourself on that one. But where you can compromise yourself a little bit is in not buying quite so much produce. And that's what we see in our customers at the moment.

**Operator**

(Operator Instructions) The next question comes from Robbie Ohmes with Bank of America.

**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD & Senior US Consumer Analyst*

I actually have a few modeling follow-up questions. The -- I think these are probably mostly for you, Chip. The first would be adjusted D&A was about \$30 million in the first quarter. Is that the type of number we should use for DNA roughly for the next 3 quarters?

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

Yes. There will be slightly higher, between \$30 million and \$35 million for the next 3 quarters.

**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD & Senior US Consumer Analyst*

Got you. And then I might have missed it, the store closings. Did you close all 11 in the first quarter? Or are they closing in the second quarter, some of them? Or...

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

We closed 1 in the first quarter. The other 10 are in the second quarter. But when you make the decision to close the stores is when you have to book the charge. So since we made the decision in Q1, we had to take the charge in Q1, the bulk of it.

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**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD & Senior US Consumer Analyst*

Got it. And can you give us the rough new store openings by quarter?

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

Hold on a second. So we should have -- we ended Q1 at 395. We're in Q2, call it, 392. And Q3, at 401. And then Q4 at 407, plus or minus.

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

That's not the stores that we're opening. That's our total store. Total.

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**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD & Senior US Consumer Analyst*

I think we can back into it. That's helpful. And the last 1, maybe for both of you. Is just the -- the adjusted EBIT margin was super high or very nice this quarter. How are you thinking about the sustainable EBIT margin annually for Sprouts?

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

You're talking longer term?

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**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD & Senior US Consumer Analyst*

This year and longer term, should we be thinking like a 6-plus?

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

Yes. I think the adjusted EBIT margin, 6-plus is -- we're looking at, based on our guidance for the full year. I mean, this was a big quarter. Of course, first quarters are always going to be our highest quarter because that's our biggest quarter of the year from a sales perspective as people get on to their sort of new year's diets.

But we're in mid-5s. And I suspect, as we go out into the out years, as we think about our algorithm, we're probably looking at flat gross. And then we're probably going to work hard to be flat on G&A. So our operating margin will be, call it, a push, while we're still growing 10% square footage.

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**Operator**

(Operator Instructions) The next question comes from Kelly Bania with BMO Capital Markets.

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

Was curious if you could talk a little bit about the magnitude of traffic. I think I heard in earlier question about maybe double-digit inflation and a high single-digit decline in units per basket. So just curious if you could talk about the magnitude of traffic and how that trended.

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

So the traffic in the first part of the quarter was down. We were cycling Omicron and the King Soopers strike from last year, and then it rebounded. And net-net, we had -- we don't give the number, but it wasn't tiny, but it wasn't huge. It was -- if we could do it every quarter at that number, that's where we'd be.

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

Okay. Okay. And you kind of touched on a little bit Q1 maybe seasonally strong. But as we look at this gross margin this quarter and even for the past really 2 years, that your Q1 gross margin is typically your highest, and then it kind of moderates from there maybe by 80 to 100 basis points.

Is that a similar kind of pattern that we should expect this year? Or maybe just any other factors that as you think about and are planning gross margin? Any color that you could share?

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

So that is very similar. That's driven by 2 things in Q1: one is, just because (inaudible) volumes, we get a little bit more leverage on your distribution and transportation, so your fixed costs associated with (inaudible). And the second is it's just the mix of the product, the fact that you're going to -- you're just our biggest quarter of the year, it's just a slightly different mix than any of the other 3 quarters.

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

That's very helpful. And maybe I'll just add 1 more. since those were quick. But I think I heard you say 60% of your business was from high-frequency customers, and that sounded like a new insight to me. And I was curious if you could maybe talk about how you're getting that, what you're doing with that, what you're seeing in terms of traffic from those high-frequency customers versus maybe those -- the other 40%? Maybe just expand on that data point a little bit for us.

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

Well, those are our most important customers, and we're trying to get more of them, and it's about getting them to spend more in the basket. But as you -- we're getting better and better at identifying, in the basket, exactly who those people are. As part of this exercise, 18% of our customers are now -- we're now sharing. We're getting much closer to the information on them.

And our high-frequency customers are the people that really are resonating with the assortment that we have and I've got specific needs around it. And that's -- those are a group of people that we are going to invest a lot more time. Clearly, if you can get lifetime value of those kind of customers, that's going to be a big part of our personalization efforts going forward.

And this part is linked to being a very tight specialist retailer as opposed to a broad mass market retailer. And I think that's kind of encouraging that those people are beginning to spend a little bit more with us. And we think they're operating in a very omni-channel way with us as well, which we're able to understand a little bit better than we have before in the past, and we'll get better at that going forward.

But we're certainly identifying an important group of people that we're spending a lot of time thinking about.

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**Operator**

I show no further questions at this time. I would now like to turn the conference back to Jack Sinclair for closing remarks.

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

Well, thank you, everybody, for taking the time to listen to our story, and I appreciate your commitment to us. And thanks ever so much, take care.

**Operator**

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

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