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EDITED TRANSCRIPT

SFM.OQ - Q3 2023 Sprouts Farmers Market Inc Earnings Call

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PRESENTATION

Operator

Thank you for standing by, and welcome to Sprouts Farmers Market Third Quarter 2023 Earnings Conference Call. (Operator Instructions) As a reminder, today's program is being recorded.

And now, I'd like to introduce your host for today's program, Susannah Livingston, Vice President of Investor Relations and Treasurer. Please go ahead.

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

Thank you, and good morning, everyone. We are pleased you are joining Sprouts on our third quarter 2023 earnings call. Jack Sinclair, Chief Executive Officer; Chip Molloy, Chief Financial Officer; and Curtis Valentine, Senior Vice President of Finance, are with me today.

The earnings release announcing our third 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.

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.

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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 morning, everyone. I'm pleased to announce another solid quarter for Sprouts Farmers Market. Our 31,000 team members' commitment to serving our customers, embracing operational excellence and cross-functional teamwork, drove comparable store sales growth of 3.9%, total sales growth of 8% and adjusted earnings per share growth of 7% in the third quarter.

4 years ago, we shifted our strategy. We started by defining our target customer segments, health enthusiasts and innovation seekers. Those 2 segments constituted a $200 billion marketplace in the United States, and we believe we could be the market leader in that space. We then set out to reach more of those customers by providing them with differentiated products and experiences that fulfill their needs and desires.

During our journey, we focused on several critical initiatives, including developing a smaller, more profitable store prototype and accelerating store growth, while evolving an efficient supply chain that provides more freshness. We focused on innovation and our assortment with a strong bias toward our differentiated Sprouts brand portfolio.

We expanded our omni-channel strategy and also shifted our marketing approach from weekly unprofitable discounts to messages highlighting our differentiation. Additionally, we focused on implementing systems and processes to improve our operations, better utilizing store labor and developing talent across the organization. We're beginning to see the fruits of those investments and they are driving our performance.

However, there is still plenty of work to be done to capture the opportunities in front of us. We remain focused on improving all aspects of our business. In a moment, I'd like to turn it over to Chip, who will provide a closer look at our third quarter financial performance and outlook for the remainder of the year.

Before doing so, I want to congratulate Curtis Valentine, our current Senior Vice President of Finance, who will take over as our new Chief Financial Officer on January 1, 2024. Curtis has been with Sprouts for over 8 years and possesses a wealth of retail experience. Our Board of Directors, leadership team and team members greatly respect and support Curtis, and we all anticipate a seamless transition.

I want to congratulate Chip on his upcoming retirement and acknowledge his positive contributions to Sprouts as a member of our Board and executive leadership over the last 10 years. I am grateful for his partnership as we are ushered in our new strategy, and more importantly his friendship since I've been at Sprouts. I wish you all the best.

With that, I'll turn it over to Chip for what he says is his career's 40th and last earnings call.

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

Thank you, Jack. I appreciate the kind words. For the third quarter, total sales were $1.7 billion, up $122 million or 8% from the same period in 2022. This increase was driven by comparable store sales growth of 3.9% and the addition of new stores. Comp transactions or proxy for traffic were positive every period of the quarter in stores and online, while as expected, sequential increases in average unit retails and decreases in units per basket lessened as we progressed through the quarter.

Our e-commerce sales grew 16% during the quarter, representing 12.1% of our total sales, and we opened 10 new stores. For the first 3 quarters of the year, we've opened 24 new stores, all in new prototype, acquired 2 previously licensed stores and closed 11. We ended the quarter with 401 stores. From a category perspective, both perishable and nonperishables produced positive comp sales with particular strength in meat, grocery, dairy and frozen.

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The quarter's performance was also supported by better in-stocks, especially on our Sprouts Brand products. Sprouts Brand sales grew 14% and represented 20.5% of total sales, as we continue to grow this innovative category of products only found at Sprouts. Unlike traditional grocery private labels, our Sprouts Brand is positioned as better-for-you, high-quality and attribute friendly.

The value of the Sprouts Brand resonates with our core customers as we continue to receive recognition and rave reviews. For example, the Sprouts Brand organic Vanilla Creamer went viral on social media this past quarter for containing only 4 ingredients, all of which are considered clean, which is unheard of in the creamer space.

Turning to gross margin. The third quarter gross margin was 36.5%. Excluding the impact of special items, adjusted gross margin was 36.6%, a decrease of approximately 10 basis points compared to last year. Slightly favorable merchandise margins offset by expected pressure from our new and recently expanded warehouses in California and Texas.

SG&A for the quarter totaled $503 million. Excluding the impact of special items, adjusted SG&A totaled $502 million, an increase of $41 million, representing approximately 30 basis points of deleverage compared to the same period in 2022. This expected deleverage was predominantly driven by new store openings, wage increases and labor investments in our store sampling program.

Like most retailers, we expect wage increases to continue to apply some pressure for a couple more quarters when compared to the previous year. However, we are beginning to see labor markets loosen and wages stabilizing sequentially. Store closures and other costs totaled approximately $3 million for the quarter, while depreciation and amortization, excluding depreciation including the cost of sales was $32 million for the quarter.

Our earnings before interest and taxes were $88 million for the quarter, while interest expense was $2 million. Net income was $65 million and diluted earnings per share were $0.64. Excluding the impact of special items, adjusted earnings before interest and taxes were $90 million and adjusted net income was $67 million. Adjusted diluted earnings per share were $0.65, an increase of 7% compared to the same quarter in the prior year.

Our cash flow and balance sheet remain strong. During the third quarter, our cash generation of $114 million allowed us to continue to invest in our business. We spent $64 million in capital expenditures net of landlord reimbursements. We also paid down $25 million of our bank revolver and returned $32 million to our owners by repurchasing 831,000 shares.

We ended the third quarter with $252 million in cash and cash equivalents, $150 million outstanding on our $700 million revolver and $22 million of our outstanding letters of credit. As we evaluate our expectations for the remainder of the year, we continue to monitor customer spending and behaviors in the mixed economic environment.

For the full year, we expect total sales growth of approximately 6.5% to 7%, comp sales growth of approximately 3%, adjusted earnings before interest and taxes between $387 million and $393 million and adjusted earnings per share of between $2.77 and $2.81 assuming no additional share repurchases. That said, we do expect to continue to repurchase shares opportunistically.

We are on track to open 30 new stores this year, all of which are in our smaller, more cost-effective current prototype. Capital expenditures net of landlord reimbursements is expected to be between $190 million and $210 million. For the year's fourth quarter, we expect comp sales of approximately 3% and adjusted earnings per share between $0.42 and $0.46.

Before turning it over to Jack, I too would like to congratulate Curtis. I've worked with Curtis for a very long time at multiple retailers and I'm confident he will serve this company and shareholders well for many years. I also want to thank my 31,000 teammates, our Board of Directors and Jack for allowing me to play a small role in the Sprouts journey.

With that, let me turn it back to Jack. Jack?

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

Thanks, Chip. Our results signal the alignment of our merchandising, marketing, supply chain and operational initiatives, propelling our strategy forward. The management team we have built up over the past few years is growing together, and our efforts are paying off. I'm particularly delighted by our solid traffic growth throughout the year.

We are steadily making progress on the unit growth front. In 2021, we opened 12 stores; in 2022, 16. And this year, we're on track to open 30, all in the new more cost-effective prototype. Our pipeline remains strong with nearly 100 approved stores, 60 executed leases and the expected opening of approximately 35 stores in 2024, with close to 70% in the back half.

Our supply chain continues to evolve and improve. Our new Southern California DC is now fully operational and already improving freshness to our largest market. Our ripening rooms added in Arizona, Texas and our new California DC this year increased sales and margins in avocados and bananas. Together with the stores, the teams have enhanced their processes with the help of added systems, leading to better in-stocks and forecasts.

We continue to expand East, we're closing our Georgia DC, optimizing our Florida DC network for more scale and ensuring freshness with a new partner in the Northeast. We continue to focus on innovation and differentiation, which sets us apart from other food retailers. As Chip noted, our Sprouts brand grew 14% in the third quarter as we launched new meals, snacks, beverages and seasonal items.

Sprouts Brand seasonal assortment expands yearly, bringing back classics like Pumpkin Spiced Apple Cider and adding new items like our gluten-free mini maple cookies, making us more relevant each holiday. Additionally, we are one of the fastest-growing retailers of grass-fed beef, making up over 50% of our beef sales.

We continue to expand in categories like frozen with the release of our dairy-free frozen desserts, and we have revitalized sampling to drive customers to rediscover these items and other gems like our unique chili, lime rolled tortilla chips. As well, our innovation center is becoming more popular as we highlight new vendors and products.

We highlighted mocktails for dry July to great fanfare, taking advantage of this growing trend. Our merchants are rising to the challenge of bringing these products to life in the store and online. New category management capabilities have helped us analyze more trends and inside data to understand customers' shopping habits and desires.

Our teams are planning earlier and align the organization even stronger behind key themes and seasons like back-to-school, which was up high single-digits this year. These events reflect our unique customer mindset as they think and shop differently when they come to Sprouts. As the quarter progressed, these changes resulted in improved brick-and-mortar traffic.

Digital and online marketing have been leaning heavily into video and social, e-mails and searches in telling our unique story. Marketing, hand-in-hand with merchandising, has been driving our (inaudible) "Solved bySprouts" campaign, which ties into how our products address our discerning customers' needs.

E-commerce has remained solid at over 12% of our total sales, a dramatic increase from 2% in 2019. Our research shows an online delivery customer is a valuable omni-channel customer as nearly 80% of our online customers also shop in-store. And as a bricks-and-mortar customer starts using e-commerce, their spending increases more than 30%.

Our awareness scores have also seen a 10% lift since the beginning of the year. These initiatives have resulted in more frequency from our existing customers and growth in new customers. We are in the early days of our digital initiatives, but are encouraged by the initial results. In-store improved operational systems aided ordering and planning.

As Chip mentioned, our in-stocks are improving, and our store teams are delivering our objectives. In-stock, sampling and service stores were added to the store goals at the start of the year, resulting in the highest customer service stores in our company's history. Since 2019, we've invested

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almost $400 million in our team members in the form of increased wages, training and bonuses, resulting in improved retention and enhanced store experience for our customers.

We are also in the midst of developing a loyalty plan to further engage our customers. Our initial research told us our customers strongly desire a program from Sprouts. They want a program that helps them live and eat better, while driving our innovation and differentiation for them to explore. We're working through the structure and expect to release a summer pilot next year.

In the meantime, we continue to build more muscle around personalization with added data and improved knowledge. Overall, our results demonstrate our strategic initiatives are taking hold, as we become a leader in the natural and organic space. When we recently asked why customers shop at Sprouts, they said, we own natural and organic and we carry differentiated products.

This sentiment is precisely what we wanted when we started this journey 4 years ago. We still have a lot of opportunities to grow, but all our combined efforts are beginning to resonate with our customers.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from the line of Ken Goldman from JPMorgan.

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

Just curious if we could get a little more detail on how you see the path ahead for your gross margin? This is the first quarter in almost 2 years in which it didn't expand year-on-year. Still doing quite well, obviously. But just curious how we think about, or should think about modeling into the fourth quarter? And I know it's a little early to talk about 2024, but any basic thoughts you'd have on that line item would be helpful.

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

We're really confident that we can manage the gross margin [quite] around flat. This quarter it was down 10 bps. That was really a drag from the expansion of our distribution centers, both in Texas, as we said on the call -- Texas and California. There's a little deleverage there, but our merch margins are hanging in there. In fact, they were [up some] and steady and traffic is up. So, we feel good about that, and our merchants are really laser-focused between mix and pricing, et cetera, that we think gross margins will be flat next year.

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

And just a quick follow-up. How is the competitive environment right now within produce? Are you seeing anything unusual in terms of competitors discounting, doing anything to gain customers in a way that might not be rational?

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

We haven't seen anything irrational so far, Ken, and produce is always a volatile category as you know. And so things go up and down in different categories, and parts of the category change at different times. But we've certainly not seen any significant investments from anybody in the produce space.

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Operator

And our next question comes from the line of Leah Jordan from Goldman Sachs.

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

I just wanted to ask a follow-up around gross margin. I understand the pressure from the warehouse expansion. But just curious what was the biggest surprise since it did come under a little bit to your flat guide? And then how did promotions track to your plan? And I guess, when should we start thinking about your ability to leverage the warehouse expansion costs and when store growth support that?

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

Yes. So the growth as it relates to any surprise, we did guide [to] flat. I mean, it was de minimis, plus flat, could be plus 10% or minus 10% is the way we look at it. Any surprise there, shrink was a little higher, nothing scary. We're a pretty low shrink business in general. It was a little higher than we expected. But other than that, merch margins are really solid.

As I said, they continue to stay solid. The D&T will continue to be a drag for probably a couple of quarters, and so, we'll have to manage through that. The merchants are working hard to try to manage through that. And we feel really confident. I suspect Q4 might look similar to Q3. We might be flattish to maybe down a couple basis points. And then going into next year, we're feeling pretty good that we can manage around that to be really close to flat.

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

And we're very confident the investment in our distribution centers is going to pay us dividends in the long run in terms of both the capabilities of driving freshness to the customer and in terms of getting our cost -- long-term costs down.

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

And then my follow-up is just on quarter-to-date trends. If you could provide any color there, just as your guide implies some deceleration?

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

Yes. So we're guiding to about a 3% comp. And so, we feel really good. I mean, we're 1 month in and feel solid around that 3% comp, and we'll keep working towards there.

Operator

And our next question comes from the line of Rupesh Parikh from Oppenheimer.

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

So first on new stores. So as we look at new store productivity, at least how we calculate it was above our expectations. So curious how new stores are performing versus your internal expectations? And then what your specific new store productivity calculation is?

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

So, we don't -- there's a timing -- if you're looking at any given quarter and (technical difficulty) new store productivity, because of the timing of when they open, it can throw the numbers off. So as it relates to us, we're just looking on our -- we look on average, -- how is our sales per square foot average and considering that we're putting new stores in the ground.

And we're doing that. We're continuing to see that stay relatively flat despite the fact that we're accelerating our store growth at lower volumes. And we look at how our performance of new stores are relative to our pro formas. We feel that we're working towards those pro formas and they're on track to deliver the shareholder value that we've outlined in our long-term guidance with our store new store model.

So if you sit here -- and I apologize, but to go through the new store productivity, we would probably be here 15 minutes trying to go through a spreadsheet that I don't think would be of a lot of value to any of us. So maybe offline we can walk through it.

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

Yes, I certainly spend more than 15 minutes talking to Chip about this, Rupesh. I'm really pleased with the new store performance. I mean, there's ups and downs across the different -- across the country, in our less established markets, in our more established markets. But we're opening stores right across the country at the moment, and I'm pretty encouraged where we're at. And the way we set this off a few years ago and moving to smaller stores, I think, is definitely derisked the program going forward, and we're feeling pretty confident with where we're at.

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

And then maybe just one follow-up question. So on an almost 4% comp, there was deleverage this quarter. Just any insight as you look into next year in terms of what type of comp you may need to deliver to leverage expenses?

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

Yes. Well, as you remember, we did guide to deleverage for the year, which implies the back half was going to have some deleverage. The acceleration of new stores combined with just wage pressures -- a bubble of wage pressures that we've all been working through is probably going to create a need to have a slightly higher comp for the next couple of quarters to deliver some high single-digit earnings growth with our share buyback.

So it's going to take a little bit more. But I think once we get steady state and get through this timing of going from 16 to 30 to 35 plus, is just getting through that and then these wage pressures. But we're working hard at it.

Operator

And our next question comes from the line of Edward Kelly from Wells Fargo.

Anthony Bonadio - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

It's Anthony on for Ed here. I just wanted to dig in on the Q4 guidance a little bit. It looks like it implies continued softness in margins. I'm getting something like 20 to 30 bps of EBIT margin compression at the midpoint. I guess, one, do you guys agree with that? And then two, can you just dig in a little more on what's driving that assumption and the different puts and takes just across gross margin and SG&A?

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

Yes. Well, on the gross side we'll probably be flattish to similar to this quarter, maybe down just a [hair]. And then there will be some delivered deleverage on SG&A as we implied all year. The back half was going to be some deleverage on SG&A. What's causing that again -- as again, we've had a really back half loaded new store growth here that bubble is coming through, and we've got some wage increases that we're working through.

Anthony Bonadio - *Wells Fargo Securities, LLC, Research Division - Associate Analyst*

And then just on inflation. I guess, are you still contemplating inflation in that mid-single-digit range for Q4? And then any early reads in terms of how we should be thinking about '24?

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

Yes. As it relates to inflation, we had said on the last call that we expected for the back half to be low to mid-single digits, and that was an average for the whole half. So that's been coming down year-over-year. That inflation rate driven is a year-over-year compare, and that is coming down as we expected it, and prices are stabilizing as we expected it.

But at the same time, the units per basket is stabilizing as well. So our expectations, as we go into the [3%] comp for Q4 is, it will feel it's getting closer and closer to what I would call normalization. We've got -- we're expecting some positive traffic, and we'll still get a little bit of AUR increases from a year-over-year perspective, and the units will start to be in a very less dilutive environment.

And as that flows through to next year -- we feel like at this point, it's early in the budget stages for us, and we don't have a crystal ball. But the idea that we're getting to a place of normalcy where it's about driving a little bit of traffic, you get a little bit of AUR and the teams are working really hard to get a little bit more units in the basket.

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

And the thing that encourages us, Anthony, about going into next year is the traffic trends. We're seeing pretty strong traffic in both bricks and mortar, strong traffic in our e-com business. And it kind of gives us confidence that the assortment that we've been putting together has got differentiation. So, the context of the marketplace that Chip outlined, I think is bang on.

We're not going to see the level of inflation in 2024 that we've seen in the last couple of years. But the unit trend has been encouraging in that sense and [then] the slowdown has been slowing down. And the context that we're really encouraged about is traffic going into 2024, which should sustain our top line business going forward.

Operator

And our next question comes from the line of Mark Carden from UBS.

Unidentified Analyst

This is actually (inaudible) on for Mark. Just on the quarter, what have you seen with respect to the consumer behavior through the quarter in light of some of the recent pressures consumers are facing? Any change in patterns relative to last quarter? Or is it pretty consistent overall, whether it be [UTTs] trade down to more affordable options in more private label?

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

I don't think we've seen any really significant different trend in Q3 than we did across Q1 to -- beyond the point that Chip outlined a little minute ago, which was inflation -- the level of inflation is flattening out a little bit. We're still seeing inflation as we predicted, and the unit change is not slowing down as much. Customers are spending as much money on food, and we're very encouraged by the trends towards our assortment.

I think people -- I think the pandemic drove this a little bit. I think people are trending towards more about immunity, more about attribute-based products, understanding what -- and we're seeing that across our portfolio, whether it be plant-based, whether it be grass-fed, those kind of attribute-based products, keto and paleo and gluten-free. We're seeing real strong trends in those spaces, and I think that's been driven by the pandemic as much as anything else.

There is a little bit -- there has been some trade down in certain places in terms of cuts and meat and that kind of thing. But by and large, the trends in Q3 are in line with what we've been seeing. And as I said in our last conversation, we're encouraged by the traffic trends that are coming, and we think that's driven by some kind of macro issues around our type of customer and our target customers that may not be being [merged] in other places.

Unidentified Analyst

And secondly, in the event comp slow next year, I was curious if you would prioritize market share gains or protecting your margins? And also, can you please remind us some of the leverage that you can pull to manage expenses if comp slow next year?

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

First of all, the context of market share and margin is not the way we think about our business. Our market share -- we concern ourselves with the target customer that we have, which remember only something like $200 billion of the $1.2 trillion marketplace. We're [concerned] ourselves with the target customer and growing share of wallet with that target customer, and that's the entire focus.

And the market share that we really pay attention to is the market share of natural and organic. And that's something that we feel we've got -- had a good run on that over the last few years, and we're encouraged by the trends at the moment in that space. So when you talk about market share, we think it's all about looking after our target customers and being increasingly relevant to them.

And we don't see a promotional solution or a margin investment solution to do that. The way to do that is to get the right products in the store, deliver in-store, (technical difficulty) customer service scores are high. And we're getting some really good scores on that in terms of looking after the customer and giving them what they want in this target customer environment that we're in.

So, we don't see this dynamic of we're going to have to invest margin to get growth in top line sales. We talk about how can we look after that target customer better and better. And in terms of -- we've got some opportunities to be more efficient in our business going forward. I mean there's clearly some wage pressures, which is actually not such a bad thing.

And we'll be driving our business to make sure that we get as much efficiency as we can in terms of the replenishment into our stores, in terms of handling pricing in our stores, in terms of handling our registers and the checkouts in the stores. There's a number of things that we can do in our distribution centers that we've invested in going forward, so -- and some investments in systems and IT.

So, we've got some opportunities to drive some efficiencies going forward that maybe cover some of the SG&A challenges that we're going to face over the next couple years.

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Operator

And our next question comes from the line of Mike Montani from Evercore ISI.

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

Just wanted to ask about SG&A dollar growth into the fourth quarter. And then I understand it's early, but into [CY '24] as well. So, if we think about store growth accelerating towards 10%, even though they're a little bit smaller stores, should we be thinking about double-digit increases in SG&A at the total company level? And then does that suggest 2.5% to 3% comps or more to lever? I just wanted to ask that, and then I had a follow-up.

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

Yes. As it relates to the remaining of this year, the SG&A dollar growth -- pure dollar growth in Q4 will look similar to the growth in Q3. Some of that is -- again, it's the new stores predominantly and then the wages side of the house. As it relates to next year, again, we're into the -- we're just beginning our budget process for next year. It's too early to tell.

That said, certainly, we're an organization that works really hard to deliver value to the shareholders and create shareholder value. So, we're going to -- we'll be knowing that we have some wage pressures, will continue through next year. We're looking under every rock and corner to find places for efficiencies, as Jack said, so we can deliver meaningful results next year as well.

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

And then just in terms of the comp of 3.9% for this quarter, can you share what was the traffic contribution to that, as well as how much inflation was there year-over-year in the number?

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

Well, we don't give specifics on traffic, but we had solid positive traffic. And as we had said, the inflation has come through similar to what we said at the end of Q2, that we expected low to mid-single-digit inflation through the back half of the year. And it's on the high end of that in Q3, but it's been coming down.

Operator

And our next question comes from the line of Scott Mushkin from R5 Capital.

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

Chip, I'm going to miss you, but I'm sure you've got big plans for retirement going forward. So congratulations. So I guess you guys are trending a little bit different than the industry, because if you look at the industry, overall volumes really are not budgeting as inflation comes down. And as a result of that, at least our data is showing competition is ramping up in certain markets, just the way it's very regional. So I guess as you look at '24, what will make you guys look much different than the industry, if these trends continue?

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

Yes. I think, Scott, we've talked about this a lot. We just don't think we're the same as everybody else in this grocery space as the way things are evolving and developing. We've got a very specific assortment that's very different to other people. We sell a lot of bulk. We sell a lot of vitamins and supplements. We sell a huge amount of produce relative to the rest of the industry.

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Those kind of dynamics make the mix that we evolve, and what happens in our business, very different. So, I find it very difficult to compare comp sales across the grocery sector. We look at our own comp sales and our own ability to grow within the target customers that we have. And that's the entire focus of the business. We do get some context for that in terms of where the natural and organic mix goes and where the share goes in that space.

But we feel that we continue to do -- and we're on a good trend at the moment, we continue to do what we're doing, which is doubling down on assortment differentiation, doubling down on customer service and sampling, and creating an environment inside the store that's exciting, doubling down on the digital side of our business in terms of communicating more directly and in a more personal way.

But we've got the ability to grow a little bit of share of wallet of our target customers. And what happens with -- in the rest of the grocery industry, whether some regions having a battle on pricing or not, hasn't really got -- I know it sounds -- and I don't mean it to sound in this way kind of dismissive.

But ultimately, it doesn't really matter, because if we do the right thing by our target customers, we can grow our business and we can make sure that we deliver against the aspirations of our shareholders and the team here in Phoenix. The opportunity is in front of us, but the opportunity is about the target customers that we have, and it's less about us being very promotional against an environment that's changing or that kind of dynamic that -- we can get sucked into that conversation.

Our priority is our target customers and delivering that target customer and assortment, in service and in the quality of our store business in front of the customers. If that helps, Scott.

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

I would follow on a little bit.

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

Sure.

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

Scott, I would follow-on a little bit, just to remind all of us that it's highly sensitive price promotion customers. We asked them to step away lightly. Years ago -- and so that is not the model that we're in. And as we sit here now, we're not -- we're no longer losing volumes. Our volumes have stabilized, so a really good place. And we're really focused on the things like Jack said, traffic solid and things like sampling to get people to put that extra thing in the basket.

Our in-stocks are improving. Our innovation centers are adding new items into the stores that people are getting excited about. And then when they start to take off or if they take off, they become in line and they're only at Sprouts. So, I think we're doing a lot of things that are working towards the ecosystem that we're working with them.

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

And so, still a little thunder for my follow-up question. But I guess looking at the deck you had on your website and the economic model going forward where it said low single-digit comps is kind of what you expect. Let's just say that this idea that specialty is going to grab more share and you as part of that industry will grab more share. And then we look at the store base and the growth in the number of stores, talk me through why it wouldn't be higher than low single-digits? It seems like you could be setting the stage for 4% or 5% comp, not 2%, 3%?

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

Scott, that's a really reasonable point of view given what we're doing. I do fundamentally believe there's going to be more health enthusiasts in the future than there is today. And there's certainly more today than there was 5 years ago. So, the trend is in line with what we're trying to do. I think importantly, in terms of the model that we're building and in terms of the kind of algorithm that we're putting in front of our investors, I think it's appropriate to be prudent.

And I think that's exactly where we're being at the moment. I don't disagree with your fundamental point and don't underestimate the aspiration that we would have as a business to be in a very different place. We would like to be in a different place.

But I think it's very appropriate that we put the right numbers in front of where that we're comfortable with and that allows us to manage our business around that number as opposed to manage our business under a number that we -- that's more aspirational than fundamentally underlying our algorithm going forward.

Operator

And our next question comes from the line of Robbie Ohmes from Bank of America.

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

My first question, Jack, I just wanted to clarify, I think you said 35 stores for next year, and I thought you guys have been saying that you might be working towards 40 stores for next year. Is 40 off the table for next year?

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

Not really. Where we are as we look at the stores and opening of the stores, our expectation is we could have more than 35. We have several in the tail end of the year, so it's pretty back half loaded. And if we have any slippage -- we just don't want to provide a number out there, there's slippage in the middle of the year. So right now, we feel really confident of 35. We have more in the pipeline. It's just we're kind of managing [if] there's Q4 slippage.

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

And I think it's appropriate to do that in the context of the marketplace. The construction is a little bit uncertain in certain locations. And that's the only reason we've been a bit cautious (inaudible). Like we said in the script, we've got 100 signed off -- sites that have been signed through our real estate committee, and we've got, I think, 65 or 70 leases already signed.

So, we've got plenty in the pipeline to make this work. This is just really trying to reflect what might happen in December -- in November, December next year as opposed to January, February, and 35 is [sort of] comfortable, maybe we'll get a few more.

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

And then just on the digital strength, is that -- can you talk more about what you guys are doing to drive digital? Or is it also related to the DoorDash partnership working better than expected, or Instacart still performing well? Any help on that would be great.

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

Well, we're comfortable with our partnerships with both Instacart and DoorDash. They have come into the business and added some value to us in terms of understanding the customer and using some of that dynamic and some of that information. I think we'll be able to use more of that going forward. So, I'm quite excited about the relationship with both of them, not just with our [owned] e-commerce business, which has been pretty strong for us, but also in terms of the data and the understanding how we can use that information to help us communicate digitally.

If you look back over the last 3 or 4 years in terms of our communication, we've fundamentally changed this from our paper-based communication play to a much more digital-based communication play. And we've made some progress on the personalization side of digital communication.

While I've been very pleased with -- in the marketing communication, is that there's so many different -- one of the teams -- [one of the] things that the marketing team comment a lot is there are so many stories that you can tell for our business because we've got such a variety of attribute-based stories to tell people, whether it be gluten-free or keto or paleo or plant-based or -- that those stories can come alive.

And we can make them come alive, and the way they've done it really, I think, quite successful and it will get better, is how we've communicated digitally and how we're picking the right -- and we've changed our media agency. We're operating in a different way with -- around our media and trying to get a bit more bespoke in what we do. And I think we've made some progress on that.

And basically, going forward, digital is going to be -- the digital communication is going to be the key to what we're doing going forward. And we've made some progress, but got a long way to go.

Operator

And our next question comes from the line of Krisztina Katai from Deutsche Bank.

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

And I add my congratulations to you, Chip as well. So a question on the customer engagement focus that you've had in '23, right? You've launched new marketing, you have personalization efforts. And with that, as we think about the consistent positive traffic that you've been seeing, can you maybe talk about how much incremental wallet share you are taking? And what are you seeing on customer frequency across their various cohorts? And just how to think about the runway there to engage the lowest quartile or quintile of your customer base?

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

Yes, you said a lot there in that question, Krisztina. We've made some progress in terms of how we're communicating. We're gaining (technical difficulty) a few more trips from existing customers. And as we talked in the script, it's becoming an omni-channel game for us, [and] the really successful customers are ones that are playing in both ecom and in the physical bricks-and-mortar business.

So, we're seeing some progress on both sides of that equation, both new customers and the existing customers. All of them play into this space of these health enthusiasts. We continue to get more and more data on that space, and we continue to work hard and making sure that we really understand how much share of wallet we're growing. I think it would be probably premature of me to talk numbers on that specifically.

We've got some information on that, and we'll work -- being able to articulate that better going forward in the future. But specifically, the work that we've been doing has been very much about targeting those customers, digitally communicating with those customers and trying to bring this -- we don't have a big share of people's total grocery spend. We just need a little bit more to make this come alive.

And that's kind of what's been happening over the last few quarters as we see traffic growing both in terms of ecom traffic, bricks-and-mortar traffic. And encouragingly, we're seeing a consistent traffic growth across the nation as well, whether it be in our less established markets in Florida

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and our more established markets in California and all points in between. We're seeing a consistent pattern across the board, which is giving us a lot of encouragement.

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

And just a follow-up question on unit growth. It sounds like 35 is the number that you feel very confident in for 2024. But as it relates to opening the stores on time and staffing them, is there any difficulty that you might be having in terms of recruiting labor and retaining them? Or that's really just you trying to be more sort of conservative with the opening schedule and potentially do better than what you're planning for?

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

Well, certainly, the 35 is based on potential -- either construction challenges going forward as opposed to labor challenges going forward. If anything, it's got a -- little bit, we're seeing more applications for jobs in our company than we've ever seen before, and the quality of applications are getting better. As you know, it was quite a challenging environment through the pandemic in terms of filling our stores and filling the jobs that we had.

We're catching up and caught up and beyond on that in terms of the quality of applications again, and a number of applications. Retention rates are at a good level as ever been in our company. And I think that's part of how we build the culture in here. One of the things is there's a [DNA] in our company that people actually like working in an environment where they think they're doing good for the planet and good for the customers and good for the community.

So, we feel as if retention -- retention has been always in a good space and applications are in a good space. So labor is -- getting people in the stores isn't a challenge. The 35 is more based on is there going to be some slippage from November, December into January next year.

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

Yes. But I would also add that, yes, I think our store operations teams or HR teams, marketing teams are doing a really nice job of building that muscle, opening up quite a few stores in a short amount of time. If you just look at how many stores we opened this quarter, that's a pretty big number for us, and we're getting better at it each and every quarter. So, I think the talent is there, and I think we've really developed the muscle on how to do it.

Operator

And our next question comes from the line of John Heinbockel from Guggenheim Partners.

Unidentified Analyst

This is Anders Myhre on for John Heinbockel. Can you walk us through how the produce distribution centers work in terms of initial productivity and the path from margin dilution to accretion? And also, how do you expect these PCs to benefit gross margin at maturity?

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

So as it relates to the dilution, we added a lot -- it's DC dependent somewhat, where it's located, how many miles is going to take off the ground, how big it is. In this situation we went to a much bigger DC in Southern California. So it's bigger space that's underutilized because we're going to grow into it. And then we expanded a bunch of space in Texas. Again, we're going to grow into it.

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So from a dilution perspective, the expectations, they're probably going to be dilutive for the 12 months -- the first 12 months that they're open. And then at that point, probably a push. And then you'll get leverage probably -- you'd probably get leverage out of it. It's going to be 24 months out from opening the 36 you start to get some leverage, because you've created real -- you've created capacity that you're now building into that you're starting to leverage.

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

And the capacity will support the store programs that we've got in California. We've built a distribution center in Florida that's going to support it. We've built capacity in Dallas, in Wilmar and Texas to support it. So, we've now got capacity to support the new stores that are coming on board. And going forward, it gives us some options in terms of distributing, [both] more broadly outside the produce space as well. So it's given us a lot of options in terms of efficiency. And I'm anticipating that in the not-too-distant future 2, 3-year window, we'll start to get some efficiencies in our distribution costs.

Unidentified Analyst

And to follow-up, what is the early read on the 2024 pipeline of stores, especially in the context of the new DC, so I guess, the clustering by market?

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

Well, we said in our release that we think we'll get approximately 35 stores in 2024. Beyond that, we've got 100 sites that we've signed up in our real estate committees, and we've got 70 leases that are already signed. That continues. The real estate committee sees probably 6, 7 stores a month at the moment in terms of guiding to this portfolio. So, we feel confident going through '24, '25, '26 that our store portfolio growth will be in line with what we've been anticipating all the way through. But '24, I think you asked specifically about, we're seeing approximately 35.

And I think maybe your question was leaning in towards like what markets, and if that's the case, it's probably going to be about a 50-50 between what we call established and non-established markets. So think about it from Florida, the East Coast is probably going to be 50% of those stores, and the Southwest of the West Coast is going to be the other [50].

Operator

And our next question comes from the line of Chuck Cerankosky from Northcoast Research. Chuck, you might have your phone on mute. Still not hearing you, Chuck. Would you like me to move on to the next question?

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

Yes, let's do that and then we can come back to Chuck, if we can catch them at the end.

Operator

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

Benjamin Wood - *BMO Capital Markets Equity Research - Senior Associate*

This is Ben Wood on for Kelly. So I wanted to start by asking maybe the inflation question a little differently. We believe in the past you guys have talked about Sprouts inflation tracking similar to food-at-home CPI, which we estimate decelerated about 300 basis points quarter-over-quarter. Wondering if that was consistent to the magnitude of slowdown you saw? And then can you provide any details on the subcategory level? Help

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us understand pricing in units in some of your major categories like vitamins produce, center store? And finally, you mentioned units are improving, but is that in the categories you guys would have expected them to?

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

As it relates to the -- if you talk particularly Food-at-Home inflation, that's probably about right. It's not too far off. As it relates -- I'll skip to the Unit 1, is -- the units are -- they're continuing to stabilize, and that's across -- as we've mentioned many times, the area where we had our biggest challenge was in produce, which is -- as we said, that was sort of a trade down, right?

Our customers instead of trading down, they were trading out our produce unit. We have -- the most number of units in the basket are produce, and it's the lowest price point unit. We're beginning to see that stabilize as well. So across our categories, it's getting -- from a units perspective, it's getting what I would call healthier in the fact that they're stabilizing. And what was the other question, Ben?

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

What are the categories? So maybe although -- capture that a little bit, Ben. Our inflation number is always going to be a little bit different because of the mix dynamic in our business. There's a little bit of a -- produce is always a bit more volatile, and we've got a bigger proportion of produce in our business. So, we've got to watch that. We have been encouraged by what's been happening in our produce business, as Chip said, in terms of this decline in units just slowing down a little bit.

And we're seeing some strength in our bananas business and avocados business, given we've invested in significant capabilities in terms of improving the quality and the freshness and the presentation of those products. So our produce business has seen some encouragement. I've been really pleased by dairy, frozen, grocery where we get real attribute differentiation, and that's flowing through really strongly in terms of our business.

And it's probably slowing down a little bit in terms of inflation in that space as well, in line with what we -- or may be in line with what you talked about in terms of your question. So we're feeling that those dynamics, that change our inflation number. But the overall story that Chip's been -- we've been talking about now in the call and in previous calls, where you see a slowing down of the level of AURs and the decline in units is [slowing] down at the same time. So it's coming into sync, which is what we think is going to happen going forward.

Benjamin Wood - *BMO Capital Markets Equity Research - Senior Associate*

And then just a follow-up on the previous line of questioning on digital. By our math, digital has been a pretty solid contributor to comp year-to-date. Wondering if you could help kind of quantify how much of digital growth has been driven by the incremental new partnership with DoorDash? And then as we think about Q4, which I believe is when you would start to lap the initial DoorDash rollout, what are your expectations for digital growth as you start to lap?

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

Well, I think as we shared in this call, we see omnichannel as the key to our business going forward. The way customers are navigating and drifting between coming to the store and using online is driving basket and driving this share of wallet that's important to us with our target customer. So digital plays a key part, ecom plays a key part in that whole dynamic going forward.

Instacart and DoorDash have been great partners this year. The DoorDash -- Our business is now we -- saw -- when I joined the company, we were at 2% mix. We're now running around a 12% mix in terms of our ecom business. And that's steadily growing a little bit as we go through. But as I say, the customers that are using online, are definitely using -- coming to the store as well, which I think is an unusual mix quite how much

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omnichannel we've got, which again gives us a lot of confidence that our assortment and our curated assortment that's differentiated is proving very relevant.

And I think there's more work we can do with DoorDash and Instacart to really understand that target customer so that we can communicate more effectively through some of the digital mediums that we've got going forward. So it's an encouraging picture, but it's not something -- we don't think of our business as ecom and non-ecom. We think of our businesses omnichannel and that we're providing a service and providing an assortment for that target customer. However, they choose to engage with us.

Operator

And our next question comes from the line of Bill Kirk from ROTH.

William Joseph Kirk - *ROTH MKM Partners, LLC, Research Division - MD*

Chip, by my count, this is your third attempt at retirement. So hopefully, third time is a charm. And Jack, you touched on this, and you just touched on it. But at times, I think you've quantified like roughly how many shoppers that you have good data on. So could you remind us like what that percentage is today, like the percentage that you know? And then with these new programs that we've been talking about, what does that percentage become over time? So you're this today and you go to what, over a few years?

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

Yes. Well, I think we've talked about it in the past. And the combination of different ways we get to it comes to around 13% of our customers that we've got good information on, which is pretty low. We anticipate the work that we're doing in terms of the loyalty that we've talked about, the work that we're doing in terms of understanding how this digital communication works.

We can get that higher than where it is, but it doesn't need to get to the kind of numbers that you see in the more traditional grocery space. We don't anticipate it going -- it doesn't need to go terribly high for us to make a lot of progress on this in terms of communicating it. I don't want to commit myself to numbers on that at the moment because we haven't quite got that nailed, but we're doing a lot of work on it, Bill.

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

And we do have a pilot next year, the loyalty program. Part of the purpose of that is to actually be able to get a lot more information, to be able to connect with our customers a lot more in the early stages of that. I suspect will -- that number will grow pretty dramatically in the early stages of that, and we'll be able to talk to those customers, at least on a broad-based basis and then to be able to get down to the individual customer will probably be a little bit longer journey, but I think we're on the right road for that.

Operator

This does conclude the question-and-answer session of today's program. I'd like to hand the program back to Jack Sinclair for any further remarks.

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

Yes. Thanks, everybody, for your interest in our company, and it will not be long before we're giving you full year numbers in a few months' time. So, we look forward to that, and I wish everybody a Happy Halloween. Take care.

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Operator

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.

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