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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market Fourth Quarter and Full Year 2017 Earnings Call. (Operator Instructions) And as a reminder, today's conference call is being recorded. I'd now like to turn the conference over to Susannah Livingston, Investor Relations. Please go ahead.

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

Thank you, and good morning, everyone. We are pleased you have taken the time to join Sprouts on our fourth quarter year-end 2017 earnings call. Amin Maredia, Chief Executive Officer; Jim Nielsen, President and Chief Operating Officer; and Brad Lukow, Chief Financial Officer, are also on the call with me today.

The earnings release announcing our fourth quarter and full year 2017 results, our 10-K and the webcast of this call can be accessed through the Investor Relations section of our website at sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding our future performance and growth, product expansion, new store openings and 2018 expectations and guidance. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in our forward-looking statements. For more information, please refer to the risk factors discussed in our filings with the Securities and Exchange Commission, along with the commentary on forward-looking statements at the end of our earnings release issued today.

In addition, our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to the GAAP figures, please see the tables in our earnings release.

For the fourth quarter ended December 31, 2017, diluted earnings per share was $0.29 as compared to $0.12 in the same period in 2016. For the full year 2017, we reported diluted earnings per share of $1.15 compared to $0.83 in 2016. Excluding the noncash benefit of $18.7 million related to the enactment of the Tax Cuts and Jobs Act in 2017, fourth quarter diluted earnings per share was $0.16, an increase of 33% and full year diluted earnings per share was $1.01, an increase of 22% from 2016.

With that, let me hand it over to Amin.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. Sprouts has truly evolved into an everyday healthy grocery store loved by our customers. This is evident by the continued momentum we have seen at Sprouts throughout 2017. Despite an overall deflationary environment and disruptive headlines during the year, our laser focus on our priorities around product innovation, enhancing customer experiences both in and out of store and investments in our team members drove solid performance in 2017.

For the year, net sales increase of 15%, same-store sales of 2.9%, new store productivity higher than historical averages, and operating cash flow and diluted earnings per share both increased 22%, all beating our guidance set at the beginning of 2017 and industry leading. Our leadership team is extremely proud of our store, regional, distribution center and support office teams for their passion towards our mission of health and their dedication and hard work during the year.

Let me touch on fourth quarter and full year results. Sales were strong across the store and across all regions during the fourth quarter. Customers' interest in quality and healthier holiday options continue to grow, which led to another very successful holiday season with record sales. Our continued refinement of our offering is positioning Sprouts as a holiday destination of choice for more and more customers.

Traffic remained strong during the year and accelerated at the end of the quarter, in part, due to a benefit from the New Year holiday shift. Inflation remained muted and ended flat for the fourth quarter. Our successful full year top line and bottom line results were driven by certain key factors. First, our continued growth in private label, which increased 30% in sales year-over-year; our enhanced deli program, now in more than 130 stores, are giving our customers more grab 'n' go options throughout the day and continued to increase our deli penetration. Our investments in our team member training and technology are paying dividends, evidenced by sales per hour productivity gains, improvement in operations, including in-stock position, improved team member retention at all levels, the highest customer service scores in our company history and 23% of our store team members earning a well-deserved promotion during the year.

On the marketing front, our revamped grassroot marketing efforts continue to increase brand awareness, particularly in new markets, and we're excited to leverage this approach in our 2018 new market entries.

Finally, we continue to benefit from improved analytics, including better promotional decisions and cost improvements. Before I shift to 2018, I want to highlight successes in our sustainability efforts as it's becoming increasingly important to customers in their decision on where they shop.

Sprouts has committed to a zero waste threshold by 2020. We're approaching this target through several waste diversion initiatives we have been implementing, which focus in 3 major areas. Food, field and feed. Food that is no longer in retail condition but remains perfectly edible and nutrient rich is donated to local hunger relief agencies. Food that is not fit for hunger relief agencies is sent to cattle farms or compost facilities, closing the loop on food waste. More than 115 million pounds of food have been diverted from landfills and over 55 million meals have been donated since we have started these programs back in 2013. We continue to build on our sustainable sourcing and building practices, tackling areas such as energy efficiency, water conservation and greenhouse gas reduction. I would invite you to read up on these initiatives on our website in our first Sustainability and Social Responsibility Report, which will be out next month.

Let me now turn to 2018 priorities. In 2018, we want to continue to accelerate our efforts in our strategic priorities, including product innovation, customer engagement and experiences, investing in our team members' success and technology investments to drive cost efficiencies and better position us as we scale.

First, we want to continue to lead the industry with our trend-based product innovation and category management. Private label remains a top priority. Our revenue growth in private label has been 30% or greater for the past 7 years and we believe private label can grow into the mid-teens penetration in the near to midterm from the 12% today.

Our consumer insights are showing tremendous results from customers around private label particularly in the areas of trust, taste and differentiation. In 2018, we'll be introducing more unique items rooted in health, taste and attributes across the store. We're also excited about continued -- continuing to expand our private label offerings in our fresh departments under our Sprouts sub brands, Sprouts Market Corner Deli, The Butcher Shop at Sprouts and Sprouts Fish Market. We'll also continue to work with our branded manufacturer partners through our win-win sales-focused approach and continue engagement with smaller innovative brands to remain a trend leader in the industry.

Second, we want to continue to strengthen our customer engagement and experiences, both in and outside the store. We are testing various in-store enhancements to drive in-store experience for today's and tomorrow's customer preferences. Outside the store, there are several initiatives including expanding home delivery, our new website and mobile app and building on our grassroots awareness program in new markets.

We launched Phase 1 of our improved website and mobile apps several weeks ago. Our digital goals here are clear, to help customers deepen their knowledge of health, inspire them to eat healthier, discover new products and save time and money when shopping with Sprouts. In addition to hundreds of educational resources and thousands of recipes, users can build virtual shopping lists based on current pricing and promotion in their store and scan product bar codes directly to check for mobile coupons. And we have additional plans, which we'll announce later this year.

Also, earlier this year, we announced our intent to offer home delivery of Sprouts products in all of our major markets and launched our new partnership with Instacart. This customer convenience also allows Sprouts to extend our trade area, helping drive incremental sales, given the wider spacing between our stores compared to conventional operators. Given this opportunity, we view home delivery as incremental and not a deleveraging requirement. This positions Sprouts uniquely in our sector.

Third, we will continue to invest in team member training to deliver a differentiated Sprouts customer experience and create clear pathways for our team members' career success, which is important for our new store growth. I will speak more on this in a minute.

Lastly, we'll be implementing significant technology to enable us to continue to scale and drive efficiencies. During 2018, we will implement fresh item management technology to reduce operating complexity, drive better in-stock, reduce shrink and integrate our production needs with our labor management system. Department rollouts will occur throughout 2018 and early 2019, and we expect efficiency gains in 2019.

Lastly, our business intelligence work continues to advance and enhancing promotional effectiveness and facilitating better and faster business decisions for our merchandising teams.

Shifting to new store growth. In the fourth quarter, we opened 3 new stores, ending 2017 with 285 stores in 15 states. For 2018, our pipeline remains strong with 52 approval sites and 44 signed leases for the coming years. We're excited about our entrance into the Mid-Atlantic this year, starting with our first store in Maryland opening next month. In addition, our expanding footprint will also bring our healthy brand to 3 additional new states, Washington, South Carolina and Pennsylvania for a total of 19 states by the end of the year.

Lastly, let me address an important topic widely discussed over the past few months, tax reform. As a company, we have been focused on investing in labor, training, systems and innovation for several years, and we are seeing clear outcomes and benefits as I described above.

To ensure we remain in a leadership position to attract the right talent, we will further invest in our team members by improving pay and improve benefits such as health care and expanding maternity leave. We will invest an additional $10 million or approximately 1/3 of our tax savings for our team members in 2018.

The investments will be strategically aligned to our long-term strategy of health, value, selection and service. Brad will cover this in more detail in a minute.

In summary, Sprouts continues to build significant capabilities to further differentiate our business and the clear response from our customers gives me incredible confidence for 2018 and beyond.

With that, let me turn the call over to Brad to cover our financial results and 2018 guidance.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Thank you, Amin. I'll begin by discussing some of the business drivers for the fourth quarter and full year, and then review our guidance for 2018, including the impacts of tax reform.

For 2017, sales and earnings exceeded our expectations as the business continued to build momentum throughout the year and we effectively leveraged those sales into solid earnings. As well, we continued to refine our capital structure and returned significant capital to our shareholders in 2017.

For the fourth quarter, net sales were $1.1 billion, up 16% over the prior year, driven by comp sales growth of 4.6% and strong new store productivity in the low 80s. The comp benefited by 25 basis points due to a favorable impact from the calendar shift of the New Year's holiday into Q1 of 2018, and we experienced a normalized cannibalization rate during the quarter.

Similar to last quarter, merchandise margins and labor management improved, resulting in EBITDA of $63 million, a 25% increase for the fourth quarter and a margin of 5.5% of sales, 40 basis points improvement over the same period last year. Let me discuss a few of the driving factors behind this continued solid performance.

For the fourth quarter, gross profit increased by 17% to $324 million and our gross margin rate increased 20 basis points to 28.4% compared to the same period in 2016. The majority of this increase was due to cycling the heightened promotional environment in the fourth quarter of 2016 in addition to sales leverage on other fixed cost due to higher comps.

Direct store expense increased 17% to $248 million, an increase of 20 basis points to 21.6% of sales compared to the same period last year. This deleverage is primarily driven by higher benefit costs and increased depreciation. This was partially offset by our continued improvement in labor productivity in the stores.

SG&A increased 8% to $38 million for the quarter, an improvement of 30 basis points to 3.3% of sales compared to the same period last year. This primarily reflects cycling the cost in 2016 associated with the Executive Chairman of the Board's retirement as well as higher bonus expense.

In the fourth quarter of 2017, as a result of tax reform, we recorded a onetime noncash benefit to income tax expense of $18.7 million. This primarily was due to a lower valuation of our net deferred tax liabilities. Net income for the fourth quarter was $40 million and diluted earnings per share, $0.29 for the quarter. Excluding the noncash tax benefit related to tax reform, net income would have been $21 million, an increase of 24% and diluted earnings per share would have been $0.16, an increase of $0.04 or 33% over 2016.

For the full year 2017, net sales grew to $4.7 billion, up 15%. Gross profit increased 14% to $1.4 billion, resulting in a gross margin rate of 28.9%, a decrease of 30 basis points from 2016. Direct store expense increased 16% to $963 million, an increase of 10 basis points to 20.6% of sales. And SG&A increased 17% to $148 million, an increase of 10 basis points to 3.2% of sales compared to last year. EBITDA totaled $324 million, up $30 million or 10% compared to last year. Excluding the noncash tax benefit related to tax reform, diluted earnings per share would have been $1.01, an increase of $0.18 or 22%.

Shifting to the balance sheet and liquidity. We continue to generate solid operating cash flows from operations, up 22% for the year to $310 million. We also invested $186 million in capital expenditures net of landlord reimbursement primarily for new stores. This is slightly higher than our previous guidance due to greater cash spend in 2017 related to 2018 new store openings and a lower payable balance at year-end related to CapEx as compared to the prior year. Many of these new projects are moving along quickly and ahead of schedule.

We ended the year with $19 million in cash and cash equivalents, $348 million borrowed on our $450 million revolving credit facility and 1.4x net-debt-to-EBITDA. Consistent with our capital allocation strategy, we continued returning capital to shareholders throughout 2017, repurchasing 9.7 million shares for a total investment of $203 million. We ended the year with $127 million available under our current share repurchase authorization. Year-to-date through February 20, we have repurchased 1.2 million shares of common stock for a total investment of $30 million.

And as announced today, our Board of Directors has approved a new share repurchase authorization of $350 million for a total authorization of $447 million to be used through the end of December 2019. In addition, to mitigate rising interest rates, we implemented a floating to fixed swap on $250 million or approximately 70% of our outstanding debt for the next 5 years.

And now let me turn to 2018 guidance. Net sales growth is expected to be up 11.5% to 12.5%, attributed to ongoing positive trends in the business and new store growth. As well, we expect full year comp sales growth to be in the range of 2.5% to 3.5%, reflecting continued momentum in the business. We expect stronger comps in the first half of the year due to easier compares. This guidance translates into a 2-year comp range of 5.4% to 6.4% compared to the 2017 2-year comp of 5.6%.

As Amin stated earlier, as a result of tax reform, we will invest an additional $10 million in our team members in 2018. These investments will cover some labor rate increases, shelter team members from an increase in medical premiums and improve other team member benefits. Additionally, this allows us to proactively invest in wages to stay ahead of future minimum wage rate increases in certain markets.

As Sprouts is a full U.S. taxpayer, tax reform will be a net positive for the company, not just in earnings per share, but also in cash taxes due to a higher depreciation deduction. At this time, based on the Tax Act, we expect our effective tax rate to decline to approximately 24% to 25% going forward. As we have discussed, most of the pre-IPO options that were issued will expire in April of this year and the expected stock option benefit will have the effect of reducing our full year tax rate for the year to be between 19% and 20% or roughly 500 basis points.

We expect diluted earnings per share to be in the range of $1.22 to $1.28, resulting in EPS growth of 21% to 27% for the full year. In addition, we expect the new Tax Act to enhance our cash flow in 2018 by approximately $30 million prior to any reinvestment as our cash tax rate will benefit from the full expensing of eligible capital projects. This will provide us with the flexibility to invest more in the business if needed, or return more capital to shareholders.

Our CapEx will be approximately $165 million to $170 million net of landlord reimbursement. And lastly, we will open approximately 30 new stores in 2018. A few additional items to note on the 2018 guidance. We expect inflation to be slightly positive for the full year. As it relates to margins, we expect gross margins to deleverage slightly year-over-year primarily related to deleverage in occupancy. And consistent with past practice, we will continue to make price investments as necessary to drive traffic and to maintain our competitive position.

We expect DSE to deleverage by 20 to 40 basis points. The investments from tax reform account for approximately 20 basis points of this investment. The remaining deleverage is due to investments to support our system implementations, which will enhance margins in 2019 through improved in-stock position and reduced shrink, providing us with the flexibility to invest when and where needed in the future. We also expect slight deleverage in SG&A also related to investments in strategic projects.

Below the EBIT line, we expect interest expense to be approximately $27 million, including interest related to financing and capital leases. This increase is largely due to expected rate increases and slightly higher debt balances due to maintaining a net-debt-to-EBITDA ratio of approximately

1.5x. With regards to our tax rate, as mentioned, most of the pre-IPO options that were issued have been exercised in the first quarter of 2018. As a result, we are expecting our first quarter tax rate to be in the high single digits and the remainder of the year will be in the range of 24% to 25%.

As for capital structure, our capital allocation priorities remain unchanged. First, unit growth; second, investments in the business; and third, returning capital to shareholders. As for share repurchases, we expect to maintain net-debt-to-EBITDA ratio of approximately 1.4 to 1.7x. This is a slight increase to our previous guidance range of 1.2 to 1.5x. This allows us to be opportunistic when the stock market may be disconnected from our view of intrinsic value of the company while still allowing us to self-fund our unit growth through cash flow generation and enhance shareholder returns through our ongoing share repurchase program.

In conclusion, we are very pleased with our solid financial performance in 2017 that exceeded our expectations. We remain confident in our business model and our strategic priorities to drive solid free cash flow generation, healthy new store productivity and long-term shareholder value creation.

With that, we'd like to open up the call for questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Andrew Wolf of Loop Capital Markets.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

I just wanted to ask you for some updates on the state of home delivery. Are you still in any partnership with Amazon Prime now? Or have you shifted the entire business to Instacart?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Andy, what we're focused on today is continuing to expand in new markets with Instacart. So we've opened up a handful of markets, including Phoenix and parts of California, Texas and Colorado. And so our goal is to have home delivery in all of our major markets by year-end, so you'll see us continue to expand. What we're seeing today is building according to plan. And we're seeing very strong in-store execution and that we're seeing there being real solid customer feedback. So I think we look at it from a perspective -- I can't comment specifically to the Amazon partnership, but we look at it from a perspective of we want to make sure we're there for our customers. So we'll continue to grow with Instacart in new markets.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

Okay. And just the other aspect of that, that I'd like to ask about as a follow-on is, what is the experience you're getting at stores where you're seeing a lot of usage, let's say? How far is the trade area expanding? Is it 10 miles? I mean, I understand why you should expand. It's convenient no matter where you live. So what are you seeing?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. Andy, I've talked about this before. What we're learning is for Sprouts, that the spacing between our stores helps us compared to the conventionals to capture incremental traffic in home delivery. So this is exciting for us because it fills in gaps naturally without opening stores to trade areas. And so because of that, we view this as an opportunity and not a cost burden that others may view it as. And generally, what you see in the food business is most of your customers are coming to grocery shop within a 7-minute drive time. And so when you do home delivery outside of 7 and 10 minutes, and go 15, 20 minutes out, you can capture incrementality particularly if you don't have a store in that 10- to 15-minute drive time radius. So in markets where we have that gap, we're seeing good success. So that hopefully answers your question.

Andrew Paul Wolf - *Loop Capital Markets LLC, Research Division - MD*

Are you able to -- I mean, are you able to give us a statistic as to how much is coming closer in versus outside of the typical drive time?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I mean, I think that this is still the early days of home delivery so we're not giving specific data in this market because we're still building it. And so we think about it as a competitive intelligence that we don't want to lean too far out on. But I think that the fresh home delivery business is not moving at the speed as what many out there are talking about and think that the U.S. is moving at. But we, as a company, want to be prepared for that and we think that it's giving us incrementality. And when to market and the customers start shifting that way on the fresh side, we want to be well positioned to capture that opportunity. And so we feel really good about what we're doing today to not only capture the incrementality that's there, but be ready for the future. And we're also doing some interesting things. We just launched our new web platform, mobile web platform, which allows customers to now shop their store that's set up in their app as opposed to wondering if a particular item exists at Sprouts or not and so it's tied to our inventory -- it's tied to our systems for schematics for each store. So we're pretty excited about continuing to build all the capabilities necessary as this business continues to build in the U.S.

Operator

And our next question comes Ryan Domyancic of William Blair.

Ryan John Domyancic - *William Blair & Company L.L.C., Research Division - Research Analyst*

I know it's early in the Instacart launch, but any early read on what that looks like? And then can you highlight any major differences between both an operational point of view and a financial point of view of what that partnership looks like versus others in the marketplace?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I think for Sprouts, a key sort of metric we use internally while we want to continue to be aggressive in investing and building in that business, we see today as it being a neutral to EBITDA and EBIT -- to EBIT margin in the businesses, that's kind of our goals. And so I know many other retailers have a compression because of the incremental cost or burden cost. So that's how we think about it. And so as those sales build, we think it'll be dollar accretive to each store that has -- that captures that incrementality.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Ryan, this is Jim. The only thing that I would add, again, it's really early in the Instacart rollout, but the feedback we're getting from a service component standpoint are some of the highest scores that Instacart has seen. So extremely pleased with how the teams executed at store levels as well as the Instacart partner.

Operator

And our next question comes from John Heinbockel of Guggenheim Securities.

John Edward Heinbockel - *Guggenheim Securities, LLC, Research Division - Analyst*

So maybe one for Amin and one for Jim. For Amin, your level of tax rate reinvestments, one of the highest we've seen among retailers. Clearly, the right thing to do. But when you think about the $10 million, how did you kind of come out that, that was the right number? And how do you think about the ROI, if you can think about an ROI on that $10 million? And then for Jim, if you think about -- where does private label assortment, as a percent of total assortment and percent of total space, where does that go over the next 3 to 5 years? How much greater than where we are today?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

John, I'll take the tax one and then pass it to Jim. We thought about it as, is really learning. As you know, we're a very metric-driven organization and learning organization. And the investments we've made in the past couple of years in labor and training and benefits has clearly yielded better customer service scores, better in stock position, better retention. I will give kudos to our HR teams and our field teams to really drive retention. In just 1 year, we've made a meaningful shift in our retention and also that allowed for us to promote 23% of our team members who are well trained and have more tenure with the company than 2, 3 years ago we would have. So when we thought about this tax reinvestment, we thought about it from 2 contexts is, what do we want to do to stay, to keep our great workforce and continue to develop them and continue to drive forward? And second is what should we be thinking about in terms of getting ahead of minimum wages in some of our markets, which are coming in the next 2 to 3 years? So as we looked at that entire model of what's coming at us in the next 2 to 3 years, we came up with something that we felt that allowed for us to get ahead of the game, yet be responsible in how we think about investing here. So I'm very excited about continuing to build, frankly, on our -- and get to industry-leading retention and, because we're growing so fast, allowing for a more experienced team member set to open new stores as we grow. So that's kind of the thinking and how we went at it, and we feel that it's a very fair number when it comes to shareholders and team members. So with that, I'll pass it on to Jim.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

John, looking at private label, and we're obviously an organization that are very pleased with the team and what they continue to deliver in terms of innovative differentiated products in the marketplace, which Amin alluded to in the call, that it's driving top line sales of 30% and double-digit comps. As you look under the hood, it's also being driven by a nice balance of growth in basket as well as items in the basket, so we're getting more and more customers putting that in their basket, new customers putting it in their basket. Penetration this past quarter was just over 12%, up 100. Full year, about 11.5%. We would project 2018 to be over 12%. And looking out over the next 3 to 5 years, we would anticipate being in that 14-plus-percent penetration.

Operator

And our next question comes from Alvin Concepcion of Citi.

Garrett Klumpar

This is actually Garrett on for Alvin. I wanted to go back to the tax benefit. I'm wondering how much of the $20 million net tax benefit do you think will go back to the original pricing versus the other investments in your business, share buybacks? And also want to just get your take on if you're seeing evidence that those tax reform benefits are being computed away in the industry?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes, currently, we talked about the $10 million. And of the remaining $20 million, we don't specifically talk about price investments, but what I would say is we've got great experience in systems in monitoring and determining price, where we stand from a pricing perspective in each of our markets. So we have a very disciplined approach market-by-market. And our range, our EPS range today does consider potential need to make investments, if necessary, from others' actions, be it a tax reform or otherwise.

Garrett Klumpar

Okay. And then are you seeing any evidence that, that tax reform benefit is being computed away in the industry from other players?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Not today. We've not seen any clear evidence. And of course, money is fungible so if somebody were to make an investment, the motivation to drive that, whether it was driven by tax rate or it was driven by other things they're seeing in their business or their strategic plans. So at that point, I think it's really a fungible conversation. So as we think about it is -- we wanted to ensure that we thought about it in our guidance and incorporated the flexibility to do that.

Operator

And our next question comes from Scott Mushkin of Wolfe Research.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

So I wanted to dive a little bit into comps that I think it was in the range of 2.5% to 3.5%. It seems pretty conservative given the environment. I obviously heard the 2-year stack commentary, but I was just wondering, any thoughts where you're running right now, and your thoughts on inflation for the year and then maybe -- and market share gains?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Scott, this is Brad. As you pointed out, when we're contemplating our range for the year, we obviously are looking at a number of factors, including our expectation that inflation will be very slightly positive for the year and then also looking at a 2-year stack that effectively accelerates relative to 2017. I think what I'd point out with regards to the fourth quarter comp of the 4.6%, obviously, as we pointed out in our remarks that we have had the benefit of a calendar shift of 25 basis points. We -- and that will reserve itself and be a headwind in the first quarter. Also keep in mind that as we pointed out, again, we were back to a normalized cannibalization rate in the fourth quarter and that was a 60 basis point benefit versus the prior year because we're running well ahead of the outside -- top end of our range in the prior year. And so when we think about cannibalization for the entire year of 2018, we're expecting it to be flat to 2017. So those are a number of elements that factored into our comp guidance.

Scott Andrew Mushkin - *Wolfe Research, LLC - MD and Senior Retail & Staples Analyst*

So to follow up -- and I appreciate the answers. So to follow up on that, if we were going to think about your incremental margin, given the investments that you have planned on the SG&A, if you were to run above that level, how should we frame incremental margins around better sales?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Well, I think our -- so our gross margin expectations for the year are pretty flat, only slightly leveraged with regards to some occupancy costs. And so I think we're looking at -- as every year, we get some incremental productivity wins as we talked about; labor productivity continues to be a benefit to us and then we make a determination market-by-market from our competitive price positioning how much we believe is appropriate to reinvest in price.

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Operator

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

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

In looking at the private label product additions going forward, how do you think about it, Jim, between fresh foods and nonperishables?

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

It's a good question, and probably one that I should've -- probably a little bit deeper for John. So the primary growth that we've seen over the last 3 years has been in the nonperishable side of the business. And when you create more relativity from nonperishables from our format versus a conventional format, we're close to 20% penetration in those areas. And so looking forward, we're going to have less SKUs coming out, and it'll be primarily driven in some of the fresh departments and then again, as I mentioned before, that kind of innovation type of items that are unique to Sprouts, but we've seen a decel of items, as you know, as you get to critical mass. But what we're seeing is acceleration of existing items. So it's been able to offset that decline in unit growth or SKU count growth. So looking forward, it's going to come a little bit more disproportionate on the fresh side than the nonperishable side. And then the overall penetration, just to again create relativity, we're close to 20% for the nonperishable side. So it's really close to the conventional segment.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

But the one thing I would add on the fresh side is our marketing team and Jim's team has done a fantastic job of building up the last 2 years, the Sprouts Market Corner Deli brand and The Fish Market at Sprouts brand and The Butcher Shops at Sprouts brand, and those are really starting to resonate with customers in terms of authority and quality, fresh, and we're starting to see good acceleration. And we're pretty excited about the merchandising and the operational consistency in those areas, so we're continuing to see good movement there and we'll keep investing and go deeper there which are, as we all know, part of consumer trends today, wanting more fresh food.

Operator

And our next question comes from Ken Goldman of JPMorgan.

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

One quick one. Can you help us -- I think you talked about a little bit of inflation this year. Can you help us -- walk us around the store, department by department, just in a vague sort of broad level, help us understand which departments will be more inflationary, which you expect a little bit less in?

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes, this is Jim. I'll try and keep it fairly high, but we'd anticipate flat to slightly inflationary, as Brad called out for Q1 and full year. Part of that is we'll be cycling inflationary numbers starting in Q2 and flat numbers in the back half of the year. So that number becomes a little bit more difficult. The primary drivers around the improvement in fiscal 2018 will be produce and, to a slightly lesser degree, meat, with some improvements in dairy as well.

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

And then my quick follow-up is a lot of -- I'm down here at the CAGNY conference in Florida, where a lot of food manufacturers are presenting, and they're all talking about passing along some of the cost inflation in freight to their customers. And obviously, Sprouts is one of them. Can you talk a little bit about your willingness to pass along freight costs, logistics costs? It's obviously a tighter competitive environment than it has been in years past, in general, in retail. And some retailers have been talking about maybe not passing that on. I'm just curious from Sprouts' perspective how likely you are to sort of say, "You know what? All right, it's a real inflationary problem for some of our vendors. It's something we do need to pass on to our consumers," or is it more something that you say, "No, not this time. Sorry."

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Yes. So again, we always talk about our pricing strategy, so we're going to follow those, but looking at the third party distribution, we'd anticipate certainly to see some slight cost, Atlantic cost increases starting in the second quarter and then probably trickling into the back half of the year. We'll pass those through as the competitive landscape allows us to, and so -- and all of that was reflected in our guidance that we gave you guys today.

Operator

And our next question comes from Shane Higgins with Deutsche Bank.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

Just a question, if I can get some color on the gross margin for the quarter. I think you said it was up 20 basis points. Just get a breakdown in terms of how much of that was occupancy leverage versus merchandise margin?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

So most of the increase in the quarter was merch margin. In fact, more than 100% of the increase was merch margin. We were cycling some competitive promotional activity in the fourth quarter of the prior year and that was partially offset by a little deleverage in occupancy in Q4.

Shane Paul Higgins - *Deutsche Bank AG, Research Division - Research Analyst*

Can you guys usually get occupancy leverage on 4.6% comp? Or do you need that to be a bit higher, just trying to understand kind of the element of gross and how to think about that in 2018?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes. In the context of our guidance range for 2018, we're still seeing some deleverage in occupancy because the average square footage of the box is higher than our system-wide average. And we're seeing some rate increases depending on the market. So again, slight deleverage in occupancy within that comp guidance range for '18.

Operator

And our next question comes from Karen Short of Barclays.

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

Actually, a quick follow-up on what you just said, Brad. So can you give us a sense of what the size is of the boxes in this year in terms of what's contributing -- or why you're getting deleveraged on the occupancy?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

So I think it's 2 things, if you look at over the last 5 years, Karen, is we've gone through a period of growth on 1 year, it's 17% or 14% unit growth and over the last 5 years, rents have continued to inch up slowly as cap rates have gotten -- the marketplace has gotten a little bit more competitive for great locations. And so when we look at the overall portfolio, there's a slight deleverage effect, but I think the key that we think about, that at least the team thinks about, is not only leverage or deleverage in occupancy, but what is the ROIC and the IRR of each of the new stores that we're approving and the recent vintages that we're seeing. And that continues to get stronger. So occupancy is controllable to some extent and not to other, but what's important for us is what is the IRR and ROIC doing up in new boxes.

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

Okay, that's helpful. So I actually just wanted to switch gears for a second. So looking into '18, you've explained the components of the P&L in terms of the investments that are going into DSE. So obviously, we can all back into what the implied EBITDA growth is for '18. But when I look to '19, it looks like some of these investments and headwinds go away and you should have, I think, some fairly meaningful benefits from the technology investments that you called out, maybe specifically shrink, as one of the items that you'll benefit from. So is it fair to think that '19, you might be able to return more to your longer-term algorithm in terms of EBITDA growth rate? Or is that still a little too optimistic?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes. Karen, it's Brad. That's exactly our thinking. Again, putting some additional context around 2018, as Amin mentioned, we have the luxury of the tax reform, and we're a full domestic taxpayer, so around a $30 million benefit for us. And we knew that minimum wage rate increases were coming in a number of markets starting at the beginning of 2019, and some other retailers have moved on wage rates and we wanted to maintain our extremely competitive position. So we've made a partial investment incrementally in 2018. I think if you adjusted for that incremental investment that came out of tax reform, we'd be pretty much at customary levels of double-digit EBITDA growth. And so our full expectation at this point in time is that when we look out to 2019, we expect to benefit from the significant and meaningful systems implementations in 2018 and see margin accretion into the business primarily, as you point out, through shrink production. And so I think we do move back to our growth algorithm in 2019 and beyond, and would look to see again, based on the very significant increase in free cash flow generation, partially at a tax reform that we'd be looking at a mid double-digit EPS growth.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

And Karen, the only thing I'd add about the systems is while there's -- a big component of it is shrink in terms of the deal management system, there are some other really good components inside of there. It's going to give us the ability to prove our service so we're not doing production where we should be providing a high-level service. Our in-stock position should improve. So both of those will have tailwinds from the sales perspective. And on deal management, it's more about promo optimization. So not only potentially a slight gross margin benefit, but really how do you optimize sales and give a high level of relevance to our consumer within our promotions.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Karen, this is Amin. I just want to add one more thing here is, if you kind of step back and look out outside of the deep inflationary period of '16, if you look at '17, '18, what we laid out here, and as Brad alluded to, and just really take a step back is outside of this tax investment, the company has maintained that algorithm. And I talked about new store and new store productivity and how profitable the stores are. When we step back and looking at the overall trends and inside of the health of the business and the algorithm of the business, I feel even more confident probably today than I would have 2 years ago, around the direction of the business and the ability to drive to that algorithm.

Operator

And our next question comes from Chuck Grom of Gordon Haskett.

John Christopher Parke - *Gordon Haskett Research Advisors - Research Associate of Retail*

This is actually John Parke on for Chuck. Can you provide an early read on the Instacart partnership?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I think we answered this earlier, but in short is we've had a good start. We're in 4 markets. As Jim alluded to, we're seeing great in-store execution and very solid customer feedback in some of the markets. We're seeing the high -- so overall, we're seeing the highest customer service ratings comparatively to many of the other Instacart partnerships. So the team has done an awesome job of executing and delivering what the customer's expecting.

John Christopher Parke - *Gordon Haskett Research Advisors - Research Associate of Retail*

Got it. And then can you just provide an update on like the launch of the new digital platform and targeted marketing, and kind of how the customer reception has been to those new initiatives?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

I'm not seeing the early reports where the first day, we almost brought the site down because so many people were on it. But we're excited to see there really what we're driving to. I think it's important to just, again, broadly what our desire is because Sprouts is one of the unique businesses which can do this, is really to bring health knowledge to our customers, bring more inspiration for eating healthier for our customers and then also make it convenient and easy to shop before they get to our store and then when they're in our store. So this was just our first phase launch. We've got a Phase 2 and 3 with some exciting plans to continue to connect that technology to the customer around health. You'll keep hearing these, the word around health when I think about connected technologies and make it easier for our customers. So -- but we've just launched now and I think it'll probably be a good 6 to 12 months before we can start opening up and seeing some of the things that we're seeing from the consumer insights there.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

I think the only thing that -- as you look at -- Amin alluded to, is we are seeing people spend more time on the site. We have very curious customers and so this was critical as we built this out in terms of enhanced content, not only around products attributes, how it's sourced. So we're seeing a little bit more dwell time these people go out onto the website or the mobile app today.

Operator

And our next question comes from Bill Kirk of RBC Capital Markets.

William Joseph Kirk - *RBC Capital Markets, LLC, Research Division - Analyst*

In the 10-K, it showed nonperishables as a percent of sales increasing in 2017, and perishables decreasing. With those deli initiatives, I guess I'm a bit surprised by that. Does that mean private label growth is larger than the deli contribution to the year?

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

Well, the nonperishable growth, I mean that's obviously, as we had mentioned before, the 30% top line double-digit comp growth, and being heavy on the nonperishable side, is creating tailwind. But we're also experiencing some strong tailwinds in the attribute-based categories on the nonperishable side to generate higher average retail. So they've got a bit of a tailwind there. And as we said, produce had some deflationary stuff that we had to cycle, put a little bit of pressure on the perishable side. But as we look forward, we continue to be very excited about our resilience around the nonperishable side of the business, but very optimistic about the growth incentive that the private label -- or excuse me, produce department and then continue to experience more success on the deli side with all the initiatives that we put on the market.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

The only one thing that I would add to what Jim said is that when you look at the total mix of nonperishables to perishable or specifically if you think about nonperishables to deli, which was your question, deli today is a much smaller piece of our business than the overall nonperishables business. So even though you get great -- good growth in deli, it's still a smaller, much smaller piece of the business than the overall nonperishable department.

Operator

And our next question comes from Rupesh Parikh of Oppenheimer.

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

So I had a clarification just on tax reform. So it sounds like 1/3 is going to be reinvested in the business for wages; and the other 2/3, is that a combination of additional investment that then flow through to the bottom line? So just hoping to better understand the other 2/3.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes, Rupesh, it's Brad. So as we pointed out, the $10 million or 1/3 is invested in, basically, DSE and the rest flows through down through to EPS. As we pointed out, our CapEx spending is in the $165 million to $170 million range. We'll open about 30 stores a year. And of course, we're focused on executing those key infrastructure projects on deal management and fresh item management.

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

Okay, great. And then a quick follow-up question. As you look at the competitive environment. So far, have you been -- as you look at the inflation being passed through, has it been in line with your expectations so far based on what you've seen?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I think that, overall, we're pretty happy with the overall health of the business. Just a little bit inside the first quarter, we've seen some challenges in a couple of key produce items, which is temporary; and I think we can see visibility of that clearing itself. And there's a slight uptick in promotional activity in protein, which is not a huge part of our business, but an important part of our business. But with both of those points said, I think the consumer trends and the demands we're seeing on health and attribute categories continue to be very strong.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

And the only thing I would call out, Rupesh, as you guys look at PPI and CPI, there's been a big shift in veg as well as fruit from a PPI perspective and, in some cases, being 30% inflationary passing through. I think in January, it's 4.5% on the CPI side. That's a fixed weighted basket, so our basket looks a little bit different than CPI. And some of those kind of highly inflationary categories don't present the opportunities for promotion and, therefore, would slow down movement and so it wouldn't pass through at that rate that you guys see at CPI. But overall, things are good and as we look forward, some of the supply challenges that Amin alluded to earlier on the produce side and some of the fruits and some of the different things are getting better and look good on the back half of the quarter.

Operator

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

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

Can we just take maybe a step back as we think about the comp outlook for the business? Prior to the deflationary landscape of -- or environment in that hyper competitive period in 2016, you were a good solid comp growth story. And you've done a good job of really getting back to that. But as we think about the business now going forward and the contribution from new stores and the competitive landscape, how should we think about the comp profile, the comp over a longer-term period of time here relative to where it's been? Is back 4 to 6 (sic) [4.6 %] something like that possible over time? Or are we at a new norm?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes -- I'm going to make a comment and it's not intended to be midterm or long-term guidance, is the way we think about the framework of the businesses, at 0 to 2 inflation, we think of the business, based on everything we're seeing today out there, as sort of a 3% to 5% -- 3% at 0 inflation and closer to 5% at 2 inflation. That's how we framework our business and we think about based on what we're seeing today. So -- and the components obviously there are -- is inflation depending on where it is, traffic, the benefit of new -- recent vintages coming into the comps even though with the 30 store growth, that's muted a little bit, but it's still giving good tailwinds into the number. So that's how we think about -- that's how we're thinking about managing the business internally.

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

Okay. And then just a quick follow-up, Amin. You're moving into the Mid-Atlantic at this point and the Northeast. Can you just maybe talk a little bit about how you view the market there and why you see it as an attractive market for Sprouts?

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Yes. I mean, I think it's an exciting market for us. Anytime where we see a wide range of a number of conventional operators and their range of variability in the operations and experience and reinvestment into the business, or lack of, when we see a wide range of dollars being spent where the stores are not trend driven, customer driven, what the customers want today, those excite us. So we'll see how the stores start reacting. But in some of our recent markets, we've seen some great customer response leading to our higher new store productivity. And so I think -- we think based on those components, it could be a pretty attractive market for us. And it is, D.C., in Baltimore, Philly, these are dense markets, so a lot of population there.

James L. Nielsen - *Sprouts Farmers Market, Inc. - President and COO*

I think another great tailwind we're going to see is we are a highly differentiated model and no one in the Mid-Atlantic has seen anything like what we do. So a difference in the layout, the assortment, the value proposition that we put together and anchored around a different level of service, knowledgeable base service, so very optimistic about the Mid-Atlantic and how we'll perform.

Operator

Our next question comes from Robbie Ohmes of Bank of America Merrill Lynch.

Robert Frederick Ohmes - *BofA Merrill Lynch, Research Division - MD*

I was -- just wanted to ask about the first half of the year in terms of could you see opportunity for a merchandise margin upside or strength against the promotional comparisons like you saw in the fourth quarter? Maybe just guide us through what -- or remind us maybe what you are against in the first half of this year?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - CFO, Principal Accounting Officer and Treasurer*

Yes, I think as we pointed out in our guidance, only slightly deleveraged for the full year. At this point, we don't see any significant swings between the quarters. Obviously, it'll depend on what happens in the competitive environment but, at this point in time, we don't see a lot of swings.

Operator

There are no further questions. [I'll turn the conference] back to Amin for closing remarks.

Amin N. Maredia - *Sprouts Farmers Market, Inc. - CEO and Director*

Thanks, everyone, for calling in and listening to the call and listening to the story. We look forward to meeting many of you in person in the coming weeks. Thank you.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This does conclude the program, and you may all disconnect. Everyone, have a great day.
