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SFM.OQ - Q4 2020 Sprouts Farmers Market Inc Earnings Call

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## OVERVIEW:

Co. reported 4Q20 net sales of \$1.6b and diluted EPS of \$0.58. Expects 2021 diluted EPS to be \$1.78-1.91.

FEBRUARY 25, 2021 / 10:00PM, SFM.OQ - Q4 2020 Sprouts Farmers Market Inc Earnings Call

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Ladies and gentlemen, thank you for standing by, and welcome to Sprouts Fourth Quarter and Full Year 2020 Earnings Call. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions) I would now like to hand the conference over to your host, Vice President, Investor Relations and Treasury. Susannah Livingston.

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

Thank you, and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our Fourth Quarter and Full Year 2020 Earnings Call. Jack Sinclair, Chief Executive Officer; and Denise Paulonis, Chief Financial Officer, are with me today. The earnings release announcing our fourth quarter and full year 2020 results, the webcast of this call and quarterly slides can be accessed through the Investor Relations section of our website at [investors.sprouts.com](http://investors.sprouts.com). During this call, management may make certain forward-looking statements, including statements regarding our expectations for 2021 and beyond. These statements involve a number of risks and uncertainties that could cause actual results to differ materially from those described in the forward-looking statements. For more information, please refer to the risk factors discussed in our SEC filings along with the commentary on forward-looking statements at the end of our earnings release issued today.

Our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to the GAAP figures please see the tables in our earnings release. Also, please note that full year 2020 was 53 weeks with the extra week falling in the fourth quarter, making it a 14-week quarter.

With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today. There is no doubt that 2020 was a year like no other. As the calendar has turned and we reflect on the year, the events of 2020 have only made Sprouts stronger. We generated a robust top line, with sales up 15%, record earnings and operating cash flow of nearly \$500 million. While absorbing costs associated with an increase in e-commerce sales,

the opening of 22 new stores and the payment of record bonuses to frontline team members. I'm delighted we have paid these bonuses to our team members during such challenging circumstances.

Clearly, we have some tailwinds from COVID. However, our strategic initiatives are fueling our performance and will continue to have lasting impacts. We anticipate further non-COVID-related improvements in our business in 2021 and beyond. These improvements will come as our strategy further comes alive. Winning with our target customers, our redefined brand and marketing platform, reverting back to smaller formats, strong unit growth, a focused and disciplined supply chain and best-in-class customer service. Sprouts is uniquely positioned as a specialty grocer. We lead with a fresh produce selection highlighted in the center of our store, carry a different assortment of food and provide a smaller format experience that strongly resonates with today's customer who is focused more than ever on health, wellness and innovative products. We are not a traditional grocer, and we are confident regarding our future financial targets.

Before I go further, I want to give a heartfelt thanks to all the team members at Sprouts for their service to our customers in an unprecedented year. The teams from our stores, distribution centers and corporate support office worked tirelessly together to make lasting positive changes to the company, all the while improving access to healthy foods across the country. Our customers also expect -- expressed gratitude in many ways from meaningful words of thanks to our heroic store team members to a record year grab and gift promotion, up 30% and that supports local food banks during the holiday season. The Sprouts healthy communities foundation work advancing nutrition education and access to fresh foods shifted quickly to help our communities. Schools and nonprofit organizations and helped our nonprofit organization to rapidly change their programming in response to the coronavirus. The foundation awarded \$1.6 million in grants to 130 local nonprofit organizations to provide an estimated 350,000 students with nutrition programs. Vegetables to food and secure individuals and families funded Denver city-wide distribution of home to grow Garden kits, among other support.

Customer behavior during the pandemic is well documented. Consumers made fewer trips shopped in less retailers, prepared more food at home and shopped more food online. As a result, our business had less trips and bigger baskets. We're starting to see this trend change, and we're expecting this to evolve through the year. As it was a headwind to us in 2020, we are optimistic it could be a tailwind to us in 2021 as the vaccine rolls out. Additionally, many of you have asked about our target customers. We are pleased to see that post the first wave of the pandemic, our transaction and basket performance with our target customer a stronger than similar metrics for our nontarget segments, particularly those coupon clippers. While we are still early in our strategy execution, this reinforces our conviction of our focus on target customers that represent approximately \$200 billion of food and beverage grocery sales. Our differentiation runs deep at Sprouts, with over 68% of our products being attribute driven, like Keto, Paleo, plant-based or, of course, organic. We are much different than other grocers. In case you're wondering, we were -- as we were going through this analysis, we decided all produce was vegan. As well, maintaining a natural health regimen continues to be important to our core customers and is especially heightened during these times. This trend resulted in organic for the total store, representing 23% of our sales and an increase of 45% in our alternative meats from brands like Beyond Impossible and products like dairy, where we were first to market. As we aspire to be the leader for developing and carrying new products in the natural organic space, the merchandising team is bringing in more brands and owned brand exclusives to Sprouts, like (inaudible), Vegan Pizza, Maala Akito Milk, also both first to market at Sprouts.

These partnerships with our vendors keep the innovation flywheel moving. Overall, 2020 brought the addition of more than 5,100 new branded and private label items, which contributed more than 35% of our sales growth. Our private label holiday program had a record performance. Even with fewer items introduced as we focused on seasonal trends like our Pumpkin spice almond butter and holiday favorites like our dark coco kettle corn. We've highlighted this strength in product differentiation even more this year with a find a new favorite campaign. All these healthy lifestyle choices have become woven into the daily lives of our core consumers, and we believe these habits are here to stay. As it relates to strategy, we have only begun to scratch the surface of our strategy in 2020, with changes to marketing our brand, a margin reset and an omnichannel ecosystem. COVID allows us to -- allowed us to accelerate our switch from print to digital channels by years resulting in more efficient media spend with our vastly expanded and targeted reach, not to mention a positive environmental impact by averting 60,000 metric tonnes of CO2 annually. Through our efforts, our customer database grew tremendously in 2020, with customer e-mails growing 50% and downloading of our Sprouts mobile app increasing nearly 60%. In total, we have surpassed 3 million e-mail addresses driven by our team members in the store through fund operational competitions like sign up showdown.

Our new brand campaign, Sprouts, where goodness grows, was released in the fall and is building awareness by reaching more customers through our first ever commercials. Doubling brand awareness, brand favorability, purchase intent and the key brand attribute sells high-quality products.

Our quick rollout of pick up at every store in the spring of 2020 and the release of shop.sprouts.com in the summer, boosted our omnichannel presence, allowing our customers to shop in a way that works best for them. Our go-to-market strategy has changed our financials for the long-term with our thoughtful approach to better everyday pricing, purposeful promotions, getting back to our roots of a produce buying organization, which is nimble and flexible. With additional investments we are making in systems and process improvements in our stores, we continue to make further advances in shrink. As we mature our go-forward pricing and promotion strategy, we continue to test different ways to stimulate new customers and transactions. With more arrows in our quiver, we can now invest from a position of strength, which we continue to do.

While there is much more to do to bring our brand promise to life, we are pleased with our progress in 2020. In particular, I am pleased with our strengthened leadership team, which is combining the best of the original Sprouts team with experienced executives brought in from the outside. They all share a passion for our mission and despite the strange Webex and Zoom environment we're all living in, the team is working very effectively together. Coupled with our new store growth, we're already markedly expanding our earnings from 2019 as demonstrated in our 2021 outlook issued today. Looking forward, I would like to highlight a few pillars of our strategy that we expect will show results this year, specifically marketing unit growth in format and our distribution channels.

First, our new brand and marketing program is vital to attracting more spend from our core customers. And while it was released in the fall, much of the heavy lifting occurred towards the end of last year. Many of our customers today fall into 1 of 2 target customer segments, health enthusiast or experience seeker. However, we're only capturing a small percentage of target customers available in our markets due to low brand awareness. Once those customers are acquired, they have a strong affinity to our stores as seen in our Net Promoter Scores. We started working with media partners, one being Verizon, who has over 350 billion daily proprietary data signals at their fingertips. We specifically target our core customer using this vast amount of data. Our marketing now spans a diverse mix of high affinity TV, radio and streaming to help build brand awareness and accelerate the reach of our message.

More personal digital touch points, like location-based shopping behavior, social media profiles and contextual targeting will help to drive individual spend. This marketing program will continue to provide value to our customers as it builds a sprouts name in a more meaningful way. For example, where we used to do anonymous marketing through our print ads, we are now utilizing customer data for digital driven ongoing targeted communications. Our unit growth story remains one of the best out there for retail. Since last year, the real estate team has been actively finding new locations, which meet our strategic expansion plans. We plan to open approximately 20 stores in 2021, slightly below our targeted 10-plus percent growth, primarily due to COVID-related slowdowns. A handful of these stores will be in our new format. And the majority will be built with a smaller footprint of 25,000 square feet less, providing improved box economics as they grow. As we look through the year, we will remodel an existing store with parts of the new format early in the summer, and our first ground up new store format will open later in the summer in Phoenix.

These first stores and a few others will pilot many of the new changes prior to opening our 2022 vintage, all in the new format. Building on the foundation of our heritage, produce will remain the heart of the store, highlighted by a low profile farmers market experience as well as personal connections with team members and a treasure hunt field. We have cut back nonproductive space in the store to allow for a very similar number of SKUs. You will also see expanded departments meaningful to our target customers, attribute messaging throughout the store to highlight our differentiated products and an innovation center to showcase new offerings. The innovation center is an important feature in the new stores, allowing our customers to see and taste new creations from Sprouts and our vendors. In fact, we will roll out enhanced innovation centers to manage existing stores throughout the year.

The 2022 pipeline is already filling up, and we plan to be at our targeted 10-plus percent unit growth next year. We will open 2 new fresh distribution centers this year, one in Colorado next month, and one in Florida in early summer. These openings will drive us closer to our goal of having our stores within 250 miles of our DCs to optimize our supply chain efficiencies and result in carbon savings of nearly 3,000 metric tonnes of CO2 from reduced miles on the roads.

Local DCs also support our desire to work with local farmers to expand the selection of unique seasonal produce and guarantee freshness to our customers. For instance, with the opening of our Colorado DC next month, we'll be doubling our local produce offering and introducing more variety categories like yellow flesh watermelon and numerous varieties of cooking greens. And we're also partnering with some young and expanding indoor and vertical growers to provide local micro greens and latices, which provide farm to fork in hours, not days. With the addition of these 2 DCs, our fresh product network will increase to 7 DCs. And the new DCs will include additional features, such as ripening rooms to serve our stores

with a fresher selection. As well, we are currently exploring how to nearly double the dollars that we sell-distribute through our DCs in future years by adding categories like dairy, bulk and some grocery items. We look forward to sharing both the new DC and the new format with you all later in the year. Sprouts has set itself on a new but familiar path. We remain a high-growth specialty grocer and in keeping with our heritage, carry unique, healthy products with our farmer's market experience, and we're evolving by reformatting to highlight our in-store experience and improve box economics are lagging our fresh distribution centers closer to our stores and attracting more of our target customer spend. We're confident this balance will result in strong total sales growth, while securing our financial returns to provide compelling value for our shareholders. We believe we are on a stronger foundation than the beginning of 2020, and we look forward to building on this with the many opportunities and growth that still lie ahead. While we have much work in front of us, 2021 will deliver strong results.

Now let me hand it off to Denise to discuss our financials in more detail as well as our 2021 outlook. Denise?

**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Thanks, Jack, and good afternoon, everyone. We finished the year strong with fourth quarter net sales growing 17% to \$1.6 billion and comparable store sales up 3.7% compared to the same period last year. Coupling this growth with ongoing strategic changes resulted in robust profitability with adjusted EBIT up 102%. As a reminder, 2020 included a 53rd week in the fourth quarter. This extra week added approximately \$122 million to sales, \$16 million to EBIT and \$0.10 to diluted earnings per share. The additional week is not included in our comp sales calculation. There are 4 key points I want to highlight today to reinforce the strength of Sprout strategy: one, our top line growth remains robust, fueled by new stores, our new stores opened strong with low cannibalization and are taking market share where they open; two, our margin structure has structurally changed for the positive; three, we have created a full omnichannel offering; and 4, our cash generation remains top-notch, even outside the pandemic rush early in the year, fueling our ability to drive growth. E-commerce sales continue to remain strong. For the quarter, e-commerce was 11% of our sales, with sales up more than 290% compared to last year. Our efforts to drive customers to shop at sprouts.com continue to gain traction growing to nearly 15% of our total online sales. Importantly, when customers enter through shop.sprouts, we capture their customer data and the seamless experience for the customer as they never leave our ecosystem.

Our customers now have a full omnichannel choice to shop how they like, in store, pickup or home delivery. Trends show that this choice changes throughout the month. 1 week, they stop our store and others they shop online, and our omnichannel ecosystem allows them this freedom of choice. At this time, we're monitoring e-commerce and help me change post COVID. Our Instacart partnership evolves as we continue to grow. For example, last year, when we rolled out our pickup to every store, we implemented a model where our Sprouts team members do the picking, bagging and delivering to the customer's car, allowing us to drive productivity and capture the related labor efficiencies. We have a solid partnership with good economics and based on our scale, our current model makes the most financial sense for now.

For the fourth quarter, gross profit increased by 25% to \$588 million, and our gross margin was 36.7%. Despite cycling the beginning of our promotional changes last year, our gross margins improved 235 basis points compared to the same period last year, driven by smarter buying, efficient promotions and continued benefits of our ongoing shrink initiatives. This even considers that once we got past the election noise, we invested deeper in target customer traffic-driving offers with integrated marketing campaigns focused on thoughtful promotions that drive brand awareness and highlight our differentiated products instead of item enterprise promotion. On the topic of gross margins, especially compared to other grocers, I think it's important to understand our margins are structurally different than many in the industry. Our product offering is different. We don't carry center of the store conventional CPG products that tend to weigh down other grocers margins. Additionally, our buying focus in produce allows us to maintain a lower-margin business through our superior buys and strong relationships with the farmers. As a result, we inherently have higher gross margins.

Moving on, SG&A costs increased \$76 million to \$464 million or 28.9% of sales, deleveraging 56 basis points compared to the same period last year. The majority of the deleverage was attributed to our higher e-commerce fees as our sales continued to remain robust. Additionally, we saw pressure from sick time as the country faced the third wave of the pandemic. As we stated last quarter, we shifted away from hourly look back bonuses, while increasing the earnings potential from performance-based bonuses for all of our store team members over the holiday season. And we're pleased that the earned payout for team members was much higher in the fourth quarter of 2020 versus the prior year. These costs were partially offset by leveraging fixed costs on increased sales as well as the 53rd week in 2020. For the quarter, our adjusted earnings before interest and taxes were \$95 million, an increase of 102% when compared to the same period last year. Our interest expense was \$3 million, and our effective tax rate

was 24%. Fourth quarter diluted earnings per share were \$0.58 and adjusted diluted earnings per share were \$0.59 compared to diluted and adjusted diluted EPS of \$0.27 in the fourth quarter of 2019. For fiscal 2020, net sales grew 15% to \$6.5 billion. The strong top line growth was attributed to 22 new stores and a 6.9% comp, partially driven by increased food at home due to COVID. Our gross profit margin for the year increased to 36.8%, up 315 basis points, driven by the strategic changes we made throughout the year as well as the COVID benefit from higher sales.

Moving from print to digital ads and to more everyday pricing, supported by meaningful promotions or substantial changes for the company. Our initiatives on shrink and better buying also contributed to this margin change and is one of the reasons we have confidence that we can retain a majority of this improvement. SG&A for the year was 28.8% of sales, deleveraging 130 basis points. The deleverage for the year was predominantly from higher operational costs from COVID-19, with the majority being related to special bonuses for our team members in the stores. Due to our record online sales, e-commerce fees and the additional labor needed to support our expanded pickup business drove additional deleverage that was partially offset by leveraging fixed costs on increased sales. Overall, the strength in our business resulted in adjusted earnings before interest and taxes of \$401 million, an increase of 84% when compared to last year and an EBIT margin of 6.2%. Our interest expense was \$15 million, and our effective tax rate was 24%. For fiscal year 2020, diluted earnings per share were \$2.43 and adjusted diluted earnings per share were \$2.49 compared to diluted and adjusted diluted EPS of \$1.25 in 2019. Our strong sales and EBIT results generated robust free cash flow from operations of \$494 million.

Consistent with our capital structure strategy, we invested \$96 million net of landlord reimbursements, primarily for new stores and utilized \$288 million to pay down debt ending the year with \$250 million outstanding on our revolver and [\$170 million] in cash and cash equivalents. Reflective of a strong balance sheet, we continue to maintain a low debt position, ending the year with a net debt-to-EBITDA ratio of 0.2x. As I turn to commentary on 2021, let me reiterate what Jack said at the outset. In 2020, we started the execution of our new strategy, and we are pleased with the progress we made in laying the foundation for profitable, accelerated net sales growth underpinned by new stores. We have tremendous white space at (inaudible) to serve more customers, fueled by enhancements in merchandising, marketing and supply chain, all of which is informed by the needs and wants of our target customers, health enthusiasts and experience seekers.

Now let me share our 2021 outlook. The impact that pandemic will have on the U.S. economy, food at home demand and consumer habits remain uncertain. Given this, the company is planning for fiscal 2021 based on a range of potential outcomes. These are our initial thoughts and note that I'm giving a 52 to [52-week] comparison. Net sales are expected to be flat to up slightly versus 2020, driven by unit growth of approximately 20 new stores, which will be back half weighted and comparable store sales down low to mid-single digits. Underpinning our assumptions are negative comps in the first and second quarter as we lap the height of COVID with an improving 2-year comp sales stack each quarter. Adjusted EBIT is expected to be in the range of \$295 million to \$315 million, adjusted diluted earnings per share in the range of \$1.78 to \$1.91. Capital expenditures, net of landlord reimbursement of \$140 million to \$160 million and a corporate tax rate of approximately 26%. As for the shape of the P&L, we believe that we'll maintain a majority of the gross margin rate improvement we realized in 2020. And we see a number of puts and takes for SG&A.

Right now, we expect that bonuses will normalize, mostly offset by annualizing COVID related costs as well as increased health care costs and sales deleverage. We continue to operate in the changing COVID landscape, and we will remain unwavering in our safety protocols for our team members and customers. We believe that the focus on health and wellness is here to stay, which bodes well for our differentiated offering. Importantly, though we are only in the early innings of our strategy, we are entering 2021 on a solid foundation, ahead of our original strategic plan we laid out last May, with a strong balance sheet and confidence that the strategic changes we began last year structurally changed our financial profile for the good. At this time, we're happy to take your questions.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions) Our first question comes from the line of Scott Mushkin. Of R5 capital.

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

So I just wanted to poke in a little bit on margins. I think Denise, you talked about that don't look at our gross margins like other grocers. But conceptually, you guys used to run at a higher EBIT margin than you've run the last couple of years. I'm wondering if you could kind of thought of as you redo the business a little bit, bring in new merchandise, make the stores more efficient, where do you think EBIT margins could maybe go. And then with that, my expectation is you're going to spend less on these stores. And so if this works, it seems like you would have ROIC that would go meaningfully higher. And I just want to see if I'm thinking about it right and get some color on that, and then I'll yield.

**Denise A. Paulonis** - Sprouts Farmers Market, Inc. - CFO & Treasurer

Sure. So Scott, thanks for the question. I think just to kick things off, if we put it all in perspective, the business has around a very strong EBIT margin at its outset from the IPO. If you think about what happened in the last few years, a lot of the promotion and promotion activity, which is trying to serve absolutely everyone and kind of everything, really wasn't working, right? To put it really simply, at this point, what we're reverting back to is not running loss later promotions because that's not the game we can win. And what that was really doing was hurting both of our sales and our profitability with running those promotions but not necessarily attracting the target customer that really would fuel the rest of the growth in the store. Fundamentally, we had cherry pickers. So ultimately, I think we believe that we can get back towards our IPO EBIT margins, which we clearly were able to do this past year, but we all recognize that part of that had a bit of COVID tailwind associated with it. I think the second part of your question, in time to ROIC and our store efficiencies, I think you are thinking about it the right way. We're really pleased with what we think we can do with this new store. We're 20% less expensive to build, 20% less expensive to operate. Hopefully, and what we can see right now, but we'll have them on the ground this year. Sales pretty consistent with what we've been able to generate historically. And you think about what that's due to, it's due to taking out the unproductive space in the store, not taking out the customer selling space and, I mean, we'll be able to maintain the same number of SKUs. So overall, I think you're thinking about the picture correctly, and I -- that is what we're trying to go achieve, get our EBIT margins back up consistently to what we believe they can run at and do that at a really efficient investment profile.

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

And Scott, just to reiterate what -- reinforce what Denise was saying. There's further opportunities that that will come with more maturity in our business. Our supply chain costs, the opportunity that we've got in terms of really being clear with our -- the exclusivity in our vendor base. And how we can work very closely with them to drive efficiency and move this -- the fact that we've got 68% of our products, all based on attribute. Attribute driven assortment allows us to manage that independently of everything else that's going on in the industry. And that's why we're feeling pretty confident about the investment profile as well as building lower stores and as well as cutting back building cheaper stores and as well as we look at the change in the promotional mix. We're pretty confident about our numbers that they can be even better than what we've talked about today.

**Operator**

Our next question comes from Rupesh Parikh of Oppenheimer.

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

So I had a question on your EBIT guidance. I was curious if you can just give any more color in terms of how to think about the split between the -- between gross margin and SG&A within the EBIT guide?

**Denise A. Paulonis** - Sprouts Farmers Market, Inc. - CFO & Treasurer

Sure. Rupesh, I would just start by saying, when we look back, and I talked about that we scenario planned, a number of different outcomes that are there. You'll see the widest range of our guidance is around our comp sales, and a lot of that is around the uncertainty that we can't control in

the marketplace. I think what we feel really confident that we can control is how we think about our gross margins and how we manage our expenses, which gives us great confidence in what we can deliver this year. Underpinning what we put out there, we expect to maintain a majority of the gross margin benefit we see. So when we think about things that were really COVID specific, there was some outsized shrink improvement when, literally, we couldn't keep product in stock in the stores during the heavy piece of COVID back in March and April. And there was some kind of outsized wins in terms of produce buying when all the restaurants and foodservice shut down overnight, and there was just a lot of excess supply right there in the market. Outside of that, we feel great about what we've done structurally with our promotions, our overall buying practices and long-term improvements in shrink. So choosing to exit having all of bars and our salad bars is a long-term structural improvement in that shrink number as there are a lot of other technology investments we're making. So think about it as a good majority of that gross margin benefit staying. And then I think on the SG&A side, this is a place where we are investing back into our business. It's really important to us to have the systems that are going to allow us to grow longer-term and put in the improvements that we need around customer analytics. But underpinning all of that, we really are striving for efficient operations, and you're going to see what we believe to be normalized bonuses, but then some of these other investment points, including around health care costs for our team members and just a natural impact of sales deleverage as we come off such a high year, where we'd expect SG&A to be not materially different than what we've seen this year, hopefully, a little bit more efficient than what we've seen this year.

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

Just to reinforce that. The fact that we've got distribution centers closer to our stores gives us much more mileage in terms of the new distribution centers will help us significantly reduce shrink and throwaways of the store. The fact that we're investing in self-checkout operations in our stores, which we're a little bit behind the 8 ball on that in terms of how we can do. So costs inside the store, cost to supplying the stores as well as this kind of more local buying and focused on buying things that are unique to ourselves. We're a unique business, and we're able to manage these things within our own way as we mature on some of the supply chain shrink initiatives.

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**Operator**

Our next question comes from Ken Goldman of JPMorgan..

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**Thomas Hinsdale Palmer** - *JPMorgan Chase & Co, Research Division - Analyst*

It's Tom Palmer on for Ken. I wanted to ask on the comp side just to kick off maybe. So comps, at least, relative to the low single-digit guidance you'd given came in a little bit better than you've guided to in the fourth quarter. So I was wondering, first, how sales trends progressed over the course of the quarter? And then maybe just get an update on the first quarter, what you're seeing thus far?

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

The quarter 4 numbers, we improved in December relative to October and November, partly because we were trying some different things in terms of how we could stimulate demand and partly because of the restaurant closures in California. So we've got a benefit from that, I think, probably improved the trends that we were getting in October, November. And January, it's a very volatile time in the marketplace. There's been a lot of crazy things happened in January and February around restaurants opening and closing around weather challenges that we had in Texas, which were obviously very significant last week. But overall, we're feeling pretty comfortable about where we are in terms of our sales so far against the guidance that we've put out.

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**Thomas Hinsdale Palmer** - *JPMorgan Chase & Co, Research Division - Analyst*

Okay. And then wanted to ask on the broader pricing environment that you're seeing thus far. You've had not just your finance promotions, but also it seems like vendor finance promotions have pulled back quite a bit in the past year, and then we're seeing increased input cost inflation

looming for a lot of these packaged food companies. So maybe what you're hearing thus far, both on promotional expectations for these companies? And also, if you're starting to have conversations with them about list price adjustments flowing through to the shelf.

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

Yes. Tom, maybe just to put a context to that. We're in a slightly different context to that dialogue that's going on between the CPG companies and the more traditional supermarkets. With clearly last year because of supply constraints, and there was a very significant pullback on promotion investment, which actually enhance the margins of the big manufacturing and CPG brands pretty substantially last year. And I think I don't quite know how that will play out in that space. But a lot of those people we don't deal with, to be quite honest with you, we're dealing with a group of people that aren't in that traditional kind of let's invest a lot of money in promotions with the big supermarkets to drive business. We're trying to -- we're working probably with smaller companies and trying to figure out the best way to stimulate demand for their products and bring new products to bear and drive innovation in the marketplace. So that dynamic of what's happening with the broader supermarket CPG relationship, we're probably not best placed to even comment on that. Cost pressures are clearly real in the marketplace. There's going to be some transportation cost pressures. There's going to be some gas price pressures. There's probably some -- depending on how the rest of the economy responds to the vaccines and demand is going to go up across the rest of the economy. And that will have probably significant implications on transportation costs for everybody. But as I say, we're trying to do our own thing, and we've got products that are just for us, and we're trying to work it through with our own vendor base. And I think we can do that independently of the things that are behind your question, Tom?

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**Operator**

Our next question comes from Chuck Grom of Gordon Haskett. .

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**Charles P. Grom** - *Gordon Haskett Research Advisors - MD & Senior Analyst of Retail*

I was wondering if you guys could compare and contrast the economics of an e-com. Purchase versus an in-store purchase, both maybe basket size contribution margin. And then just follow-up housekeeping. I believe you guys incurred about \$135 million of COVID-related costs in 2020. Just wondering how we should think about that impacting the P&L in 2021?

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**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure. So on the e-com, when you think about the fundamentals of what's the same and what's different, what's fundamentally different is the basket size. An e-commerce order is more than twice the size of an in-store order. And so that's a pretty big pick and a pretty big efficient transaction for us to have. And so nice to see that. Our in-store basket is somewhere in the low 40s, so really healthy e-commerce basket that comes through. When you think about the margins of the business, it's really interesting. We've watched more consumers more broadly to shop the store on e-commerce than they would have before. So before where you would have seen a very different mix profile of what went into that basket. You see a bit more normalized mix to what would happen in store. You're still probably a little lighter on produce. You're going to be a little lighter on some vitamins or some POBA, things that require more customer service that you might want as you came into the store. But the gross margin profile of in-store and online are very comparable. And e-commerce tends to be slightly more profitable, but we're watching that mix change as well. And then the efficiency with which we operate, we really trade-off are some of the additional store costs around cash sharing and things like that with what we pay e-commerce on our fees. So while the business -- e-commerce business isn't as naturally profitable as the in-store business, for us, it is nicely profitable heavily driven by the size of that basket coming through. So to us, every order is a good order. The fact that we have 11% penetration in e-commerce orders in an omnichannel environment actually tells us we feel pretty good about what we're doing that we're able to serve the customer the way that they want to be served. We see a continuation of new customers coming into that channel. We also see a good mix of repeat customers that shop both in-store and online and might just pick that choice differently through the week. So all in all, we think there are really complementary businesses for us and are just excited to see how much that e-commerce business was able to bring to bear this year and help customers get what they needed at home. And then your second question, which I'm actually going to forget...

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

COVID-related cost.

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**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

COVID-related costs. Yes, you have a number about right as of what we saw. If you think about the mix of what's there, about 2/3 of that was tied to store-related bonuses and incentives. And then the other 1/3 of it was really tied to all the other costs associated with COVID. So think about that as sick time additional PPE, additional cleaning in stores, all the component parts to try to keep the entire company healthy and those stores running smoothly and safely. So that's the way I'd really think about that split. As I mentioned, we do believe that, in 2021, bonuses will likely normalize. But we are conscious and aware that there could be some offset depending upon what happens with Hero pay in certain regions and things like that. So we're just watching that closely.

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**Operator**

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

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**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD*

Just a follow-up on the bonuses and pay. How are you guys thinking about wage rates? Maybe remind us what your what your entry starting wage is? And are you guys seeing pressure? I saw Costco went up another buck today. And just your thoughts on that? And then just -- well, let me give that answer, and then I just had a quick follow-up.

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

Sure. I think to be really frank, this year has been an amazing year for us to appreciate the value of the people that we've got working in our stores. I think I'm really gratified by the fact that the kind of everyday population now regard grocery workers in a much higher stem. And we've always held our people high stem. And it is very -- going to be very relevant going forward in terms of how we properly incent and reward the people working in our stores, the 33,000, 35,000 people that are working in our stores. And what we tried to do this year, and we very substantially increased the amount of money that we have paid to that group of people with the people working in the stores through bonuses that you can see from our numbers, we've been more than able to afford to do that. And going forward, we're pretty well placed because of the nature of our workforce, we've got -- tends to have a little bit higher skill base in our workforce people, who are experts in vitamins, people who are working behind meat counters, people who've got particular skills. So when I look at the kind of what's paid in the -- in our kind of -- as people look at what's happening in Walmart and Kroger and all the other folks, we're pretty well placed relative to those guys before we stop this whole enterprise. And the principle we're trying to get into, and we're testing some different things. How do we incent that group with things -- I'm a big believer the incentives for people at the stores need to be like one we incentives, one month incentives quarter incentive. Can you drive the basket a little bit higher? Can your department do a little bit better? We've experimented with those things last year, which is one of the reasons we've paid so many bonuses. And we continue to experiment with that. I want our people to walk out the door, having done a great job looking after our customers and feeling very good about how they've been compensated for that. So in terms of the specific numbers, I don't know whether Denise wants to go through that, but that's the principle that we're thinking about.

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**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

And I'll just add 2 points to that. I think you put it in perspective, we have more than a majority of our team members above \$15 an hour today, and over 80% of our full-time team members over \$15 an hour. So to put those numbers in perspective that Jack said, we think we're really well placed and actually probably running ahead on average than some other large retailers that might be out there. The second part I also mention is

because we have so many new stores coming online, and we do have these opportunities for growth, we're really focused in addition to pay for performance, as Jack was talking about with incentives, the ability to promote people and have upward mobility of folks in our store. So it's not about coming in as a cashier and staying as a cashier. You can do that but we have so many opportunities and so many more jobs to fill. It's also promoting people into higher-paying roles as well. And in 2020, we promoted about 7,200 team members, and we felt 72% of our store manager positions with internal candidates. And we're really proud of that. That's giving people the chance to move up and develop their careers and continue to earn more.

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**Robert Frederick Ohmes** - *BofA Securities, Research Division - MD*

That's really helpful. And just quickly, Jack, the industry because of COVID rolled off promotions, shut down Olivan salad bars and things like that. You guys did the same thing what do you think the expectations are going to be from your customers as the world reopens with vaccines and everything, do you think they may want some of those things back?

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

Well, some of the -- on some of the things, I think it's difficult to tell exactly how that's going to play out going forward. I don't think salad bars are -- I think the hygiene aspect of salad bars is going to make less people into -- not everybody, but less people interested in it going forward. I think the same thing applies to all of ours. Working very hard at making sure we can give customers the options that they want in those spaces without having to feel that they're compromising in any way around hygiene. I think this hygiene issue is going to be an ongoing issue post the pandemic, and that will make preparing food in a supermarket or a store environment. A bigger challenge in terms of making sure it's being done effectively and done right. Now it's never been a huge part of our business. It's been a part of our business, but not a huge part, and we're thinking very hard about how to do that effectively. I don't think it'll get anything like back to where it was. There may be a few people who want to buy, but I don't think you'll go anything like where it was back where it was. I think what will happen, I think people will go and shop more than the -- clearly, what happened in the pandemic as people shopped less and shopped more when they did shop, which is why traffic's down baskets up for everybody. And you'll see probably an e-commerce business that's higher than it was post the pandemic. But in terms of the -- what happens inside the store, I think the whole health and hygiene issue is going to become -- is it going to be a thing that's going to be here for years, if that helps in any way.

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**Operator**

Our next question comes from Chuck Cerankosky of Northcoast Research.

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

Congratulations on a great year. If you're looking at the first quarter, you mentioned that you're seeing some of the basket and traffic trends starts to -- I don't know if normalize is the right word, but head in that direction. How about the face of e-commerce order, the size of those orders? And what other areas are sort of adjusting at this time, including cost trends.

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

Well, I'll let Denise talk about the cost trends. In terms of the e-commerce basket, our e-commerce basket remains really strong. I think one of the things that I'm incurred one of the things we know is that our target customers, these health enthusiasts and innovation seekers, experience seekers. We have got so much upside in their spend. We just need a bigger share of their wallet, and that's one of the things I think we're getting from the e-commerce business, which is why the basket is so strong, and it remains strong despite some of the changes that are going on in the marketplace. And the changes that we've identified. You're starting -- it's very patchy across the country, depending on what that basically what happened last year, how strict were the lockdowns last year. So as you're looking for some comparisons, it kind of goes back and forward a little bit. But by and large, we are seeing and we expect more trips, which will relatively benefit us. And we are not yet seeing a decline in the basket, which gives me

a lot of confidence that this target that we have, this share of wallet that we're chasing. We don't have to take much many dollars from many people for us to be comfortable that the numbers we've got in front of us are achievable. Cost, do you want to talk about cost?

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**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

And very briefly on costs, we're not seeing anything particularly out of the ordinary happening in the marketplace today, if we just think about input costs related to us. We certainly see a little spike in distribution costs, just over-the-road trucks, a little escalation of that with what's been going on in Texas. But nothing outsized or completely out of the ordinary, but something we're watching. And then inflation so far has been pretty benign. We kind of came through Q4 with modest pockets of inflation, both around protein, around bakery. We started into Q1 that really hasn't seen an uptick or a big decline from what we had been trending on. So I hate to say steady as she goes because who knows what might happen tomorrow, but I'd say nothing quickly outsized to comment on right now.

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**Operator**

(Operator Instructions) Next question comes from the line of Karen Short of Barclays. This is actually Renato Basanta on for Karen.

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**Unidentified Analyst**

I guess, first, I was just wondering if you could just share some of your thoughts on e-commerce in 2021. Just what's sort of your base case in terms of growth or penetration in '21 following the 320% growth in 2020? And then wondering if you could share with us what the specific mix of e-commerce business is sourced from sprouts.com versus Instacart in markets where you already have that, that sprouts.com shopping capability rolled out? Sure. So overall, we ended the year with about 11% penetration of e-commerce into our business. I think we all know that it's going to be a very uncertain 2021 and perhaps ups and downs in all of these numbers as we watch the vaccine rollout, we watch all the other things impacting the consumer today. We're believing that there will be a bit of a moderation in e-commerce penetration, with spikes when something might happen and there might be a bulk of cases in certain places. So we aren't really expecting the acceleration to continue. But instead, it's probably moderating. That's what we know today. That's kind of how we're thinking about the business today.

And then in terms of the mix, we did mention on the call, about 15% of our e-commerce business is directly off shop at sprouts.com. So that is the data we're 100% transacting in our ecosystem. We're capturing all of that data. That is really a new capability for us that we launched just last quarter, in the end of the third quarter. So we're really pleased to see that level of penetration in that area so quickly. So Instacart is a great partner, but we're happy to have another alternative for our customer to just be directly in our ecosystem.

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

And as we think about e-commerce going forward, I think 2021 will be volatile because of the things that Denise talked about. If you get to 2022, I think e-commerce will be a high -- for food e-commerce will be at a higher level than it was in than 2019. That's for sure. It's going to be at a significantly higher level, but nothing like the level that it got to in 2020. And I think the thing for our business is if we're good at our fresh foods, if we're good at creating the experiential in-store differentiation that we are very kind of known for and the people that love us in the Net Promoter scores tell us that that's what they like about us. We believe that it might moderate even more for us. As people get past the social distancing worry of going to too many places and bumping into too many people. So who knows what will happen. But 2022, we think might not be quite as high as it might for other -- may not be as high for us as it is for others.

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**Operator**

Our next question comes from Edward Kelly of Wells Fargo. .

**Unidentified Analyst**

This is actually Stephanie on for Ed. I just had a quick follow-up on gross margin. I was wondering if you could unpack how much of the improvement this quarter was due to shrink versus the adjustments to buying and promotions? And then just more broadly, given that the competitive landscape has gotten more challenging over the years, do you feel you still need to make incremental investments in everyday price from here apart from the work you're doing on promotion or focus more on your other initiatives like marketing and data and things like that.

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

Maybe, Denise, you could take the strength. And I'll take what's going to happen going forward.

**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

Sure. So on the gross margin front, I think the important part to think about is Q4 this year is we were lapping the start of the promotional improvements from Q4 in 2019. And so relatively, where in the last few quarters, the promotional impact has been the bigger and buying has been the bigger impact and shrink being the smaller impact for the fourth quarter, that became a bit more normalized just because we were lapping some of the promotional benefit already having come through a year ago. So a little bit less benefit from promotion than we've seen in the other quarters, but some good continued trends in that shrink benefit.

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

And as we look at what we might need to invest going forward, I'm very clearly, as we've been pretty consistent on because we are differentiated and we're not carrying the same things as everybody else. We're not feeling that we're going to -- whatever happens within the more traditional grocery world. We're not feeling that we're going to have to be swayed or balanced by that. Having said that, we're taking a -- always taking a good look at certain categories. We've got to watch our vitamin margins and make sure that, that create clear differentiation for us. We've got our good right value in the marketplace, where all our project pricing, we're really pleased with at the moment relative to the marketplace. And I don't think we're going to have margin challenges going forward because I think we're going to be very clear on our seasonality and our regionality buying and getting very putting more resource into that. So we're feeling confident in that large part of our business. And our organic produce pricing, I think the gaps as wide as it's ever been at the moment. So we're feeling very confident about the things that really matter to us that we're in good shape.

(technical difficulty)

Atlantic or California, we have got more than enough opportunity where we already are to build stores and build stores that are going to create much better returns going forward than the ones we've done in the last little while. I got the opportunity last week to visit one of our 21,000 square foot stores that was built many years ago in Cupertino. I go down in the Bay Area. I go down to San Diego and I see these smaller stores, and they're so profitable and so busy and so exciting that that's what we need to go back to. And we've -- technology the way it is, we were able to review very interesting consumer, we've been doing some research on the new format stores that we're about to open. And we've had hundreds of people looking at basically a visual representation of the new stores, a virtual tour of the new store. And the feedback we're getting from the customers is kind of great because it's the same feedback that we get from our San Diego customers that are actually real. And I'm feeling very confident that we've got a pipeline, and we've got a format that's going to deliver real returns. And 2022, 2023, you'll see us getting back to the normal -- or significantly more store openings.

**Denise A. Paulonis** - *Sprouts Farmers Market, Inc. - CFO & Treasurer*

And Paul, on your EBIT question regarding the outlook. For the most part, the reflection in the increase was really carrying through what we saw as incremental benefit in Q4 of this year, realizing that a lot of that was sticky. So seeing great shrink gains and things like that, that we do believe that we'll be able to persist. The piece I'd pick up on, though, to mention what Jack had said, right? We're always on the outlook for all of the

additional things we can do to drive that productivity. We'll continue to roll out more self-checkout. We'll continue to roll out technology to make our ordering processes in the store more efficient. I think as we look forward, we think that there is good momentum for us to continue to find structural ways to be driving that profitability as well. But certainly, our Q4 results influence the change in the guide.

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**Operator**

Next question comes from Greg Badishkanian of Wolfe Research. This is Spencer Hanus on for Greg. .

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

I think in the prepared remarks, you mentioned that 15% of the online sales are now done through your in-house platform. What do you view as the biggest challenge to convincing customers to switch from a third party? And are you expecting to make any incremental marketing investments to get customers to switch platforms?

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**Denise A. Paulonis - Sprouts Farmers Market, Inc. - CFO & Treasurer**

Great question. I think at the end of the day, I'll start by going back to the view that we think all sales are good sales. So no matter what channel they're coming through or how they're coming through, it's ultimately about how the customer wants to shop. Going through a third party, there is a real benefit for some customers. If you are on and familiar with a platform that lets you tap into a number of different places that you want to order from, spanning a lot of different things, that could be your more convenient form of ordering. And that's okay, right? We value that third-party and what the third-party brings in terms of increased new customers, people who know that they can go to those platforms and find good opportunities and good stores to shop at. In terms of us recruiting more folks in, right now, it's a matter of awareness. So we're a quarter or so in to doing that. I think you'll continue to see us ramp up that we regularly talk about the opportunities of how a customer can shop with us through our e-mail communications, through our digital marketing. So that's what our real opportunity is, is to continue that conversion in that way. And here and there, we can choose to offer some incentives for them to come in and try us out. We have no challenge at all in thinking about the long-term value of that customer coming into our ecosystem and saying where it makes sense. Something to attract them could be the right thing to do. So all in all, we're looking to grow that platform for sure, but our partnership and the view that a marketplace can bring is certainly 1 that we don't shy away from. But excited about our customers finding the ability to shop. However, they would like to shop.

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**Operator**

Thank you. At this time, I'd like to turn the call back over to CEO, Jack Sinclair for closing remarks. Sir? .

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

Yes. Thanks very much, guys, for taking the time to pay attention to what we're trying to do in the business. We're very excited about the quarter and very excited about the future, and I look forward to continuing the dialogue with you over the coming months. And very excited about showing you the new format stores when we get the chance to do that. It will be nice to actually physically have meetings with people in the future and in the meantime, today, say. Thanks ever so much for your attention and your time.

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**Operator**

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect. .

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