THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

SFM - Q3 2014 Sprouts Farmers Market Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 06, 2014 / 10:00PM GMT

CORPORATE PARTICIPANTS

Susannah Livingston *Sprouts Farmers Market Inc - VP of IR*

Doug Sanders *Sprouts Farmers Market Inc - President & CEO*

Amin Maredia *Sprouts Farmers Market Inc - CFO*

Jim Nielsen *Sprouts Farmers Market, Inc. - COO*

CONFERENCE CALL PARTICIPANTS

Kelly Bania *BMO Capital Markets - Analyst*

Lauren Wood *Credit Suisse - Analyst*

Karen Short *Deutsche Bank - Analyst*

John Heinbockel *Guggenheim Securities - Analyst*

Rupesh Parikh *Oppenheimer & Co. - Analyst*

Stephen Grambling *Goldman Sachs - Analyst*

Scott Mushkin *Wolfe Research - Analyst*

Meredith Alder *Barclays Capital - Analyst*

Kate Wendt *Wells Fargo Securities - Analyst*

Andrew Rubin *Morgan Stanley - Analyst*

Chuck Cerankosky *Northcoast Research - Analyst*

David Magee *SunTrust - Analyst*

PRESENTATION

Operator

Good day, ladies and gentleman, and welcome to Sprouts Farmers Market third-quarter 2014 earnings conference call. At this time all participants are in a listen-only mode.

(Operator Instructions)

As a reminder, this conference call may be recorded. I would now like to turn the conference over to Ms. Susannah Livingston, Vice President of Investor Relations. Ma'am, you may begin.

Susannah Livingston - ***Sprouts Farmers Market Inc - VP of IR***

Thank you and good afternoon, everyone. We are pleased you have taken the time to join Sprouts on our third-quarter 2014 earnings call. Doug Sanders, President and Chief Executive Officer; Amin Maredia, Chief Financial Officer; and Jim Nielsen, Chief Operating Officer are also on the call with me today. Sprouts' Form 10-Q, the earnings release announcing our third quarter 2014 results and the webcast of this call can be assessed 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 2014 expectations and guidance. 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 filings with the Securities and Exchange Commission along with the commentary on forward-looking statements at the end of our earnings release filed today.

In addition, our remarks today include references to non-GAAP measures. For a reconciliation of our non-GAAP measures to GAAP figures, please see the schedules in our earnings release. We believe these adjusted results provide a good basis to assess the operating and financial results of the Company year-over-year. For the third quarter ended September 28, 2014, we reported diluted earnings per share of $0.17 and adjusted diluted earnings per share of $0.18. Adjusted diluted earnings per share increased 38% from $0.13 in the same period in 2013.

With that, let me turn the call over to Doug.

Doug Sanders - ***Sprouts Farmers Market Inc - President & CEO***

Thank you, Susannah. Good afternoon, everyone, and thanks for joining us today. 2014 is shaping up to be an incredible year for Sprouts as we remain focused in providing high-quality, fresh, natural and organic products at prices the everyday grocery shopper can afford. This focus reminds paramount to the success we have achieved in becoming the healthy grocery store for today's growing number of health-conscious consumers. And, of course, this focus continues to produce strong topline sales growth and excellent bottom-line financial results.

Our net sales grew to $766 million for the quarter, up 21% from 2013 thanks to strong performance in our new stores and improved comp store sales. In a competitive environment, I'm proud to report that our comp sales increased by 9% for the third quarter and 19.2% on a two-year [stack] basis. This represents our 30th consecutive quarter of positive same-store sales growth with comp levels that well exceeded overall sector growth. During the third quarter, our comp performance was balanced between traffic and ticket, as we continue to grow new customers and increase visits from existing customers. Traffic increased by 4% during the quarter. And average basket increased by 4.5% from the prior year.

Comp performance was strong across the store as everyday consumers seek healthier alternatives to the traditional supermarket and more affordable options to the specialty food store. From our extensive selection of fresh produce to our choice natural beef, cut to order in our all-time butcher shop, to our wide selection of natural and organic packaged foods, Sprouts continues to win new customers while making healthy eating easy and affordable. Additionally, as more customers embrace the need for a healthy diet, the demand for products with specialty attributes continues to grow. These fast-growing specialty categories continue to provide strong sales momentum as we leverage our extensive product offering and knowledgeable service to help customers make the educated choices needed to reach their health goals.

For the quarter, specialty categories like organic, raw, non-GMO and allergy-free all experienced comp growth well above our Company average and sales growth well outpacing industry trends. This growth in product assortment also included our Sprouts private-label products which continue to see strong comp and sales growth as consumer demand for healthier food choices continues to grow. Our Sprouts private-label is a quality, natural product line with strict ingredient standards that include no artificial colors, flavors, or preservatives. With more than 1,500 Sprouts private-label items today, we continue to expand our selection of unique items that can only be found at Sprouts, like my favorite salsa that includes flax, Chia and quinoa.

The success from our promotional strategies always drove traffic and improved sales during the quarter. Using promotional strategies like our prices and quality you can trust campaign, we continue to build loyalty with everyday consumers by providing quality, selection, and value across the store. In addition to strong traffic and category growth, the former Sunflower stores continue to perform well, hosting third-quarter comps above the company average and adding approximately 80 basis points to our overall comp for the quarter.

Now let me quickly touch on commodities and inflation. During the third quarter, as we expected, we continue to see high levels of inflation in certain categories such as proteins, nuts, dairy and produce. We also experienced tightness in certain produce categories as the growing season moved to California Central Valley, a region heavily impacted by the drought. This tightness in supply was limited in scope and mainly impacted to some stone fruits, lettuce and melons. Overall, on an average sprout basket, cost inflation during the third quarter was approximately 4%.

We expect inflation to remain near these levels for the remainder of the year, resulting in the full year 2014 inflation in the 3% range. As we move into the latter part of the year and the growing season transitions further south, we're starting to see some improvements in produce quality and supply and moderating inflation which should positively impact the margin compression that we've been experiencing in the middle of this year including the third quarter. Even during these inflationary periods, our commitment to healthy foods at affordable prices remains intact, and we continue to deliver solid traffic and comp [ex] growth across the store.

On the new storefront, we had an incredible third quarter with the opening of 14 new stores with four of those stores in our two newest markets in Kansas City and Atlanta. Opening 14 new stores in a quarter is a record for Sprouts, and I have to thank our more than 17,000 team members who helped deliver this incredible achievement. During this quarter, we also completed our remodel program for 2014, ending the year with15 stores remodeled. As most of you know, we typically don't open new stores in the fourth quarter, so we will end this year with191 stores in 10 states across the country.

In true Sprouts form, we're quickly completing our 2015 new store schedule. We're excited to enter our 11th new market, Alabama, in the first quarter of the year. Consistent with our new market entry strategy, we thoroughly studied the market and feel confident in our ability to attract new customers with our healthy living for less approach to grocery shopping. We will continue to announce new store locations for 2015 over time and look forward to our further expansion into the Southeast. Our current real estate plan includes 64 [per] new sites and 41 signed leases for the coming years, keeping us well on track with our growth strategy and long-term 14% unit growth target.

Speaking of new sites, new stores overall continue to perform well above expectations with new store productivity running north of 100% when calculated on a weighted basis. Although new stores and new markets have been part of Sprouts since the start, I'm very proud of what our team accomplished in a competitive and evolving marketplace. We constantly receive positive feedback from our customers and I'm pleased to report that our initial entry into the Southeast region has proven successful and we look forward to expanding healthy living for less into more markets in the coming years.

As we turn the corner into Q4, we are very excited about our holiday program and building on our success from 2013 we'll be adding ever wider assortment of holiday grocery items this year, including private label and specialty attribute items giving our customers everything they need for a healthy holiday celebration. In fact, several of our new Sprouts private-label pumpkin items, like our pumpkin seed tortilla chips and pumpkin gelato are already in stores and quickly becoming crowd favorites. With the best people, the best products, and the best value, we're looking forward to wrapping up our successful 2014 campaign with another strong holiday performance.

With that, let me turn the call over to Amin to talk about our financial results and full-year guidance.

Amin Maredia - ***Sprouts Farmers Market Inc - CFO***

Thank you, Doug, and good afternoon, everyone. We are very pleased with our strong results for the quarter. Following Doug's highlights of the business drivers, let me cover the operating results and updated guidance. For the third quarter, gross profit increased to $226 million, a 19% increase over the same period in 2013. Our gross margin rate of 29.5% decreased 50 basis points compared to the same period in 2013. Leverage in occupancy, utilities and buying costs were more than offset by margin compression in certain categories.

We remain focused on our core strategy of value in pricing decisions. During the third quarter, we noted that the industry was slow to pass through price increases in categories with higher levels of inflation such as produce, dairy and nuts. Based on this, we took the opportunity to pass along inflation in certain categories like meat, while continuing to invest and absorb inflation in other areas like produce, dairy and nuts to preserve value for our customers. In addition, we continue to invest in price-sensitive items in the grocery department to maintain our value proposition.

Maintaining and staying within certain price points and price ranges is an important element of demonstrating value to our customers across the store and it remains a core tenet of our strategy. To summarize the margin discussion, our strategy of staying attuned with the market and focusing on value and price points has continued to pay dividends in driving sales which continues to provide strong leverage down to the EBITDA margin line. Direct store expenses was $149 million for the quarter and as a percentage of sales was 19.4% an improvement of 100 basis points compared to 2013.

This improvement was driven primarily by leverage in payroll and benefits including lower utilization of medical benefits, leverage and depreciation in store level expenses, and a benefit from capitalization of store development cost due to a greater number of store openings during the quarter. Selling general and administrative expenses were $24 million for the quarter. SG&A included $900,000 of pretax secondary offering expenses in the quarter and $3.2 million of IPO bonuses in the third quarter of 2013. Excluding these items, SG&A as a percentage of sales improved 10 basis points to 3% compared to last year. This improvement was mainly driven by leveraging corporate overhead, offset by higher advertising costs, driven by expansion into new markets.

Adjusted EBITDA for the third quarter totaled $65 million, up 24% over the same period in 2013. As most of you know, our new store model starts with a lower store level EBITDA margin than our mature stores, and with the opening of 14 new stores this quarter, we expected the new stores to result in a compression in the overall EBITDA margin rate. However, given the strong comps, resulting leverage, and strong new store productivity, total EBITDA margin was 8.5% an expansion of 20 basis points compared to the prior year. Adjusted net income for the third quarter totaled $27.4 million, an improvement of 41% compared to 2013.

This increase was driven by strong business performance as well as reduced interest expense as a result of a lower principal balance on our term loan and an interest rate reduction under our credit facility. For the 39-week period ended September 28, 2014, net sales increased to $2.2 billion up 22% compared to 2013 driven by comp sales of 10.4% and new store openings performing well above expectations. Gross profit increased 22% to $674 million, resulting in a gross margin rate of 30.2% year to date or an increase of 10 basis points versus the prior year. Year-to-date adjusted EBITDA totaled $212 million, up 35% from the same period of 2013 well above our long-term guidance.

Shifting to balance sheet and liquidity, we continue to maintain a strong balance sheet and improve liquidity. For the 39-week period, we generated $151 million of cash flows from operations and invested $96 million in capital expenditures primarily for new stores. Due to our strong cash flow generation, we will voluntarily pay down $50 million of outstanding debt during the quarter. At quarter end, the principal balance on our term loan was $263 million leading to a net debt to adjusted EBITDA leverage ratio excluding capital and financing leases of 0.6 times.

We ended the quarter with cash and cash equivalents of $118 million and $53 million available under our undrawn revolving credit facility. With robust returns on investments, and a strong cash position, our investment focus remains on opening new stores, continuing to enhance our business through innovative sales initiatives, and maintaining superior store conditions.

Let me now turn to guidance. Our strong value proposition of promoting quality products continues to drive traffic to our stores and is clearly resonating in both our existing markets and in our new markets. That coupled with our disciplined investments and focus on management of direct store expenses and corporate costs are providing results that are exceeding our long-term guidance. Due to the seller performance to date, we are increasing our full-year 2014 adjusted diluted earnings per share guidance to $0.67 to $0.68, or a forecasted growth rate of 40% to 42%. In addition, we're increasing the following guidance as well. Full-year adjusted EBITDA growth range of 28% to 30% and 50-plus% growth in adjusted net income.

Let me review a few additional items regarding our full-year guidance. First, we expect the one-year comp sales for the full year to be in the 8.5% to 9.5% range and the two-year comp sales stacked to be in the 19% to 20% range. Second, as many of you know, during the fourth quarter our average sales on gross profit are typically the lowest of the year due to seasonally slower produce sales in the winter months. In addition, during the fourth quarter, we will be cycling a 13.8% comp from 2013 and therefore are forecasting a comp sales growth of 5.5% to 6.5%, which would lead to a two-year stack comp sales growth of 19% to 20% for the fourth quarter consistent with our performance year to date.

Lastly, as in past quarters, we expect to make priced investments as necessary to drive topline sales, a strategy that continues to drive higher bottom-line profits. However, we do expect moderation of gross margin compression versus the third quarter as the higher levels of inflation normalizes. In conclusion, Sprouts' growth is fueled by the everyday consumers' growing interest in improving their diet by making healthier food choices. This broad appeal, coupled with our promotional approach, continues to drive traffic to our stores and has led to another strong quarter of performance and gives us confidence as we plan for the future years.

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

QUESTION AND ANSWER