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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Sprouts Farmers Market Fourth Quarter and Full Year 2018 Earnings Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I would now like to turn the call over to Ms. Susannah Livingston. Ma'am, please proceed when you're ready.

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 2018 earnings call. Jim Nielsen, interim Co-CEO, President and Chief Operating Officer; and Brad Lukow, interim Co-CEO and Chief Financial Officer, are also on the call with me today.

The earnings release announcing our fourth quarter and full year 2018 results, our 10-K and the webcast of this call can be accessed through the Investor Relations section of our website at investors.sprouts.com.

During this call, management may make certain forward-looking statements, including statements regarding our 2019 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 SEC filings 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.

In the fourth quarter of 2018, we made a voluntary change to our consolidated statements of income, reclassifying occupancy cost and buying cost from cost of sales to selling, general and administration. As well, we reclassified depreciation and amortization from direct store expense and SG&A to a separate financial statement line item and combined DSE and store preopening costs with SG&A. These reclassifications had no impact on sales, income from operations, net income or earnings per share. We made this voluntary change in presentation because we believe that the exclusion of occupancy and buying cost from cost of goods sold provides a more meaningful presentation of our gross profit. These changes also enhance the comparability of our financial statements with many of our industry peers and align with how we internally manage and review costs and margin. We have applied this change retrospectively and have included a reconciliation in our earnings release filed today as well as on our website at investors.sprouts.com.

With that, now let me hand it over to Brad.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Thank you, Susannah. Good morning, everyone, and thanks for joining our call today. In 2018, we continued to evolve and improve the Sprouts business model by focusing on the latest consumer and industry trends. Our focus on product innovation, guest experience and ongoing training and development of our team members continue to underpin the success and growth of the Sprouts brand across the country. This focus drove top line sales growth of 12% to $5.2 billion for the year. Comparable sales growth of 2.1%, above our expectations and another strong vintage of new stores with new store productivity in the low 80s. Traffic and tonnage remained positive, supporting our sales performance and resulting in adjusted EBITDA growth of 7%.

Throughout the year, our strategic initiatives continued to enhance our business, leading to solid financial results. Private label sales grew by 26% in 2018, now at 13% of total company sales. More than half of our stores' delis have been remodeled with expanded offerings, providing even more convenient meal options for our customers. Our partnership with Instacart has expanded to more than 200 stores, providing quick home delivery of Sprouts' healthy and affordable products at a click of a button. Our strong cash flow generation allowed us to invest $10 million or approximately 1/3 of our 2018 tax reform savings in our team members, which has led to an increase in retention levels. Our technology investments are establishing a strong foundation that will enable us to scale efficiently. Our brand awareness also continues to strengthen as we expand across the country, leading to continued strong new store productivity in both new and existing markets.

For the fourth quarter, we ended the year with net sales of $1.3 billion, up 11% compared to the prior year. Comparable store sales were 2.3%, driven by positive traffic in basket along with less product deflation, which resulted in a 2-year comp stack of 6.9%. We continued to see growth across the store, particularly in nonperishable departments, supported by strong private-label performance. Fourth quarter sales were also strengthened by another successful holiday program. We continued to raise the bar for our holiday offerings each year. And in 2018, we saw strong results from key holiday categories along with attribute-driven products supported by new trends and flavors. This was backed by excellent store-level execution across the country.

During the fourth quarter, we opened 2 new stores, bringing our total new store openings to 30 for the year. And we closed 2 stores in December. We ended the year with 313 stores in 19 states and have a robust pipeline of new stores for 2019 and beyond. Sprouts will expand to 3 new states this year: New Jersey, Virginia and Louisiana, expanding our geographic reach in the mid-Atlantic markets and the Southeast.

Over the past few years, we have continued to refine our site selection process with the addition of more sophisticated data analytics and tools that allow us to more accurately pinpoint our core customers. These insights, combined with a more robust marketing and advertising program, have resulted in stronger sales performance in new markets. This gives us the confidence to open a greater number of stores in new markets this year. We expect our split to be roughly 50-50, existing versus new markets for 2019, versus a historical split of 70-30, respectively. We remain confident in our long-term unit growth in new markets supported by our on-trend business model, community engagement and a strong and growing brand awareness.

I'll now pass the call over to Jim to discuss the competitive landscape and to elaborate on our 2019 initiatives. I'll return later to discuss our financials in greater detail afterwards.

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Thank you, Brad, and hello, everyone. 2018 solid performance was a result of continued improvement in our retail execution and tailwinds from our strategic initiatives, driving enhanced and differentiated in-store experience. This combined with our proven pricing strategies and innovative promotions resulted in a 2.1 comp despite a consistently competitive retail landscape. We expect the competitive landscape in 2019 to be similar to 2018 with the assumption of a relatively benign inflationary environment.

Starting in the fourth quarter and in line with industry, we experienced slight margin pressure from rising transportation cost. Looking forward to 2019, we expect to see continued cost increases throughout the first half of the year and then tapering off in the back half.

Now let me move to the 2019 strategic priorities. Before jumping into those priorities themselves, I want to reiterate that both the culture of Sprouts and our strategic direction has always been driven by our passion statement: to inspire, educate and empower every person to eat healthier and live a better life. Our strategic initiatives are focused on 4 key areas: the implementation of foundational systems that will improve our business and support our future growth; continued evolution of product offerings, focus on differentiated products; enhancements to our customer experience; and ongoing development of our valued team members. We plan to complete the implementation of fresh item management in 2019, assisting fresh departments with production planning and order management.

With each department rollout, we continue to learn more and improve our operational execution. Fresh item management will allow us to optimize sales and strength through an improved in-stock position which will deliver a more consistent experience for our customers each and every day. The vast majority of expense associated with this system implementation is training, with most expected to be completed by the end of the third quarter, resulting in a higher expected training cost in 2019.

With respect to product, we've become a trusted resource for families across the country who want to live a healthier life. Our family of Sprouts brand, private-label products is comprised of a wide range of household staples and uniquely curated items that taste great and are made with ingredients you can trust.

Our private-label sales grew 26% year-over-year driven by a basket size that's 50% larger than our average basket. We continue to see a balance of both the number of items and the number of private-label items in those baskets. This loyalty to the Sprouts branded products is not only driving traffic, but is reinforcing our authority in healthy living. Today, nearly 70% of our private-label products are non-GMO or organic. We are confident that there are remaining more years of growth ahead of us and that private-label sales will exceed 16% of total company sales.

Consumer shopping preferences and healthy eating trends are changing at a fast pace, and our guest experience and product innovation teams are focused on staying ahead of those trends. 3 years ago, we embarked on a journey to elevate our deli offering with a greater selection of what customers desire. Meal solutions that are convenient, fresh and healthy. These convenient offerings including salad bars, meal solutions and freshly squeezed juice are now in over half of our stores. These customer-centric elements are even more evident in our new prototype stores. In these locations, we take guest experience to a whole new level particularly in deli and meat where design and merchandising enhancements truly highlight our differentiation, making these departments a true destination. Our new prototype will be showcased in approximately 1/3 of our stores in 2019.

We continue to grow home delivery business, which is in more than 200 stores today and will be offered in all markets by the end of 2019. While home delivery remains a small percentage of sales today, we are continuing to see a very strong sequential growth. Home delivery sales in the fourth quarter were the highest to date which we attribute to the brand strength and health in value and strong operational execution. In addition, we have started to test click-and-collect in a handful of stores in multiple geographies in order to give customers the convenience of delivery or pickup.

And when we think of marketing, customer engagement is always top of mind across all channels with relevant messaging and promotional invitations reaching our guests wherever they are. We've built a high-caliber digital and customer insights team and bolstered our internal capabilities through partnerships with industry-leading media companies. In 2019, we will continue to amplify our guest engagement with personalized offers and content, connecting with our customers wherever they are along their healthy living journey. We will also integrate our website and our mobile app to have a more unified shopping experience. These initiatives will reinforce our points of difference with all of our guest segments in both new and established markets.

I left the most important focus area for last, and that is our team members. It's our team members who drive our results through their passion to empower our guests to eat healthier and live a better life. This is a noble work, and we do it in an engaging, approachable, authentic way. The Sprouts Way. We've enhanced pay and benefits, rolled out team member wellness programs and introduced career pathing tools and focused on providing every team member with an opportunity to build a career not just hold a job. To do this, training remains a top priority with the focus on people, products and processes.

Now I'd like to turn the call back to Brad to cover financial results and our 2019 guidance.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Thank you, Jim. I'll highlight some of the business drivers for the fourth quarter and full year and then review our guidance for 2019. As Susannah mentioned, beginning in the fourth quarter, we reclassified certain expenses on our consolidated statements of income as we believe this presentation provides greater transparency of our results and enhances the comparability with many of our industry peers and better aligns to how we manage the business. We have applied this change retrospectively, so all comments today reflect these changes.

For the fourth quarter, gross profit increased by 11% to $421 million and our gross margin rate decreased by 15 basis points to 33.2% compared to the same period last year. This deleverage was primarily due to promotional investments as well as higher distribution and transportation costs at the company's distribution centers.

SG&A increased 11% to $353 million, an improvement of 10 basis points to 27.8% of sales compared to the same period last year. This leverage was primarily driven by lower workers' compensation expenses due to reduced benefit claims as well as a payroll tax benefit. During the fourth quarter, the State of California fully repaid its federal unemployment insurance loan, eliminating the requirement to pay a higher unemployment tax for California team members. This reduction in payroll tax resulted in a benefit in the fourth quarter of 2018. This was partially offset by planned wage investments in our team members as well as higher occupancy and advertising costs.

For the fourth quarter, our depreciation and amortization cost increased 11% to $28 million or 2.2% of sales, flat compared to the same period in 2017. Store closure and other costs for the quarter were $12 million compared to $0.1 million in the same period last year. This increase related to 2 special items including noncash charges of $8 million associated with the closure of 2 stores as well as onetime severance cost of $4 million associated with the resignation of our former Chief Executive Officer. Excluding the impact of the 2 store closures and severance cost, adjusted EBITDA increased 9% in the fourth quarter to $69 million. Adjusted EBITDA margin decreased by 10 basis points to 5.4% of sales when compared to the same period last year. The decrease in margin was mainly driven by the gross margin reduction and wage investments that I previously discussed.

Net income for the fourth quarter was $13 million and diluted earnings per share was $0.10. Excluding special items, adjusted net income was $24 million and adjusted diluted earnings per share was $0.19, an increase of $0.03 or 19% over the same period last year. This improvement is primarily due to higher sales, a lower effective tax rate, excluding special items of 26% compared to 34%, and fewer shares outstanding due to our share repurchase program.

For fiscal year 2018, net sales grew to $5.2 billion, up 12%. Gross profit increased 12% to $1.7 billion, resulting in a gross margin rate of 33.6%, equal to 2017 as merchandising strategies and initiatives, including private label and expansion of deli offerings, offset pressures in the competitive environment.

SG&A increased 13% to $1.4 billion, an increase of 30 basis points to 27% of sales compared to last year. This increase was mainly attributed to our planned wage investments and higher occupancy and advertising costs.

Adjusted EBITDA totaled $346 million, up $22 million or 7% compared to 2017. Excluding special items and onetime tax benefits, adjusted diluted earnings per share was $1.29, an increase of $0.28 or 28%.

Now shifting to the balance sheet and liquidity. We continued to generate solid operating cash flows from operations with 2018 coming in at $294 million. We invested $154 million in capital expenditures net of landlord reimbursement, primarily for new stores. We ended the year with $2 million in cash and cash equivalents, $453 million borrowed on our $700 million revolving credit facility and a net debt-to-EBITDA ratio of 1.7x.

Consistent with our capital allocation strategy, we continued returning capital to shareholders throughout 2018, repurchasing 11.1 million shares or 8% of the prior year shares outstanding for a total investment of $258 million. We ended the year with $218 million available under our current share repurchase authorization. Year-to-date through February 18, we have repurchased 850,000 shares of common stock or a total investment of $20 million.

Now before we turn to guidance for 2019, I wanted to say a few words about the impact of the new lease accounting standard that went into effect at the beginning of 2019. As we have spoken about previously, we leased all of our store properties and the vast majority are accounted for as operating leases with rent expense charged on a straight-line basis. Now under the new lease accounting standard, these leases will continue to be classified as operating, and we will record an asset and related obligation on the balance sheet of approximately $1.2 billion but there will be no change in the calculation of rent expense for these operating leases. Under the previous accounting standard, we had 45 store leases that were accounted for as financing leases. For these leases, the buildings and related improvements were reflected as assets on our balance sheet, and we recorded a depreciation charge and interest expense related to the asset and lease obligation, respectively. Under the new standard, all of these 45 financing leases have been reclassified to operating leases with rent expense now being recorded on a straight-line basis. This reclassification will result in an $18 million increase to our rent expense, thereby reducing EBITDA and a decrease of $11 million in interest expense going forward. These impacts are due to the change in expense recognition to a straight-line model compared to financing lease accounting under the previous standard and will result in a net incremental pretax expense of $7 million or $0.04 per share for 2019. Importantly, none of these accounting changes will have any impact on the future cash flows or liquidity of the company.

Now let me turn to 2019 guidance. For the year, we expect net sales growth of between 9% to 10.5%, driven by new store growth and full year comp sales growth in the range of 1.5% to 3%. We will open approximately 28 new stores. As well, we will have 2 stores whose leases will expire in 2019, one of which will be relocated to a new store location and the other will not be renewed. This will result in a net addition of approximately 27 stores. Net sales growth is also impacted by the 2 stores that we closed in December of 2018, which we previously announced.

We expect a normalized tax rate of approximately 26% in 2019 and this is a 700 basis point increase from 2018, mainly due to cycling the exercise of expiring pre-IPO options.

And we expect diluted earnings per share to be in the range of $1.16 to $1.24, which reflects both a noncash $0.04 negative impact from the change in lease accounting standard as well as the higher tax rate that I discussed.

For comparability purposes, if 2018 results reflected the same lease accounting impacts and tax rate as 2019, adjusted diluted earnings per share for 2018 would have been $1.14 per share or $0.15 per share lower than our reported adjusted diluted earnings per share of $1.29. We also expect our CapEx to be in the range of $170 million to $175 million, net of landlord reimbursement.

Now a few additional items to note on the full year 2019 guidance. The midpoint of our comp sales guidance range would reflect a flat inflationary environment as compared to the prior year. The comp range above and below the midpoint would primarily be related to changes in the inflationary environment as well as the competitive environment. We continue to expect to open approximately 30 stores per year going forward. 2019 openings are slightly below this level as fires in Northern California have slowed the construction and pushed 1 store opening into 2020. In addition, our store pipeline for 2019 will be more back-end loaded than in 2018. We plan to open 8 stores in each of Q1 and Q2, with the majority of the remaining stores to be opened in the third quarter. This, coupled with the 2 fewer stores in 2019 will result in lower new store selling weeks compared to the prior year.

We expect gross margins to be nearly flat year-over-year as the team improves promotional and pricing optimization, offset by increased costs at the company's distribution centers and higher transportation cost associated with more new stores in new markets.

We expect deleverage in the SG&A line for the full year. Due to the adoption of the new lease accounting standard that began January 2019, occupancy expense which is now being reported in the SG&A line will delever by 35 basis points due to this change in accounting standard. In addition, we expect pressure from cycling the wage investment we made last year that began at the beginning of the second quarter of 2018, increased training associated with the fresh item management and other systems implementations, as well as increased health and benefit cost, which, in total, will account for an additional headwind of between 20 and 25 basis points for the full year 2019.

Being a growth company, we recognize that these technology investments are critically important as they will drive efficiencies and allow us to scale the business and position us well for long-term profitable growth. We expect depreciation and amortization to continue to deleverage in 2019, similar to 2018 due to higher construction and equipment cost in addition to more remodels in 2019. We expect interest expense to be approximately $21 million, reflecting the interest and the amortization of fees associated with our credit facility and the interest expense related to the lease obligation for the remaining 4 capital leases.

The largest impact of the tax headwind will occur in the first quarter of 2019 as the first quarter of 2018 had a benefit of $0.08 per share from the exercise of the pre-IPO options.

And as it relates to our 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 our net debt-to-EBITDA ratio to be in the range of approximately 1.2 to 1.5x. This is the equivalent to our prior target range of 1.4 to 1.7x adjusted for the reclassification of 45 financing leases to operating leases under the new accounting standard. And consistent with past practices, the net debt number excludes operating leases.

In closing, we continue to evolve our unique model focused on health, value selection and service to meet the consumer needs today and into the future. We remain confident that our strategic investments are establishing a solid foundation, creating further differentiation and positioning us for continued strong financial results that will drive 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 will come from the line of Scott Mushkin with Wolfe Research.

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

So I guess my first question, and it goes to something Jim said about testing the pickup. Where are we? I think, can you give us a little bit more of that? And how scalable is that for you guys? And it seems like that's almost becoming necessary. And is this something we should see a more aggressive rollout and what will it do to the financials?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Scott, it's Jim. As it relates to the test itself, it's in multiple markets. It's a fairly small set of stores but a big enough group for us to get a good indicator on the level of success. In terms of just overall EBITDA impact, somewhat in line with home delivery, slightly less. But our home delivery is performing extremely well and so we still see it as one, it's table stakes to have it but the real tailwind for us for sales will be on the home delivery front. So we will continue to keep you apprised of the performance as we move into the year. If we get great consumer response, we'll continue to accelerate and we're prepared to do that this fiscal year, if need be.

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

Perfect. Then my follow-up has to do with gross margins. As we go into next year in the competitive environment, how are you guys thinking about it? How is it right now trending? You obviously, got a lot of news coming out of CAGNY best more on the packaged food side. So how are we thinking about gross margins as we go through the year in the competitive environment? And has there been a material change of late?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

As we talked about in the call, our projection is to be flat gross margins. We are seeing some cost increases on the nonperishable side related to freight. But all the initiatives that we've been working on with FIM, deal management, the [MPNA Group] will help offset any of those kind of margin pressures throughout the year. if you do recall last year though, we did have a nice beat in gross margin in Q1. So full year will be flat, driven by really the tailwinds from the strategic initiatives will offset some of the cost increases that we're experiencing in the first half of the year.

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

And the competitive environment?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Competitive environment promotionally is in line with prior years, prior quarters, anticipating to be the same throughout. At the shelf, as we've talked about some of the cost increases as it relates to freight in the industry, we are starting to see people pass those through. As you know, there is a bit of a squeeze. So the pass-through is -- does have a bit of a lag on it. So at the shelf, we're seeing some increases. We're not seeing people sharpen pricing. But we are seeing some pass-through and some cost increases.

Operator

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

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

Just to follow up on the click and collect. Is that something that you're testing with your own kind of network of employees? Or are you pursuing looking at that with Instacart's help? I guess I asked because some of the other food retailers or retailers are looking at different ways to leverage their digital platforms in terms of advertising and media spend. And just curious where Sprouts would stand on that longer term in terms of being able to participate in that as well.

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Yes. So there's a lot of questions in there, Kelly. It's Jim. Let's step back for a second. We're not on a unified platform today. So when you go to the Sprouts app and you go to order home delivery, you go back to Instacart. First part of the back half of the year we'll be on a unified platform. So we will be -- have our own experience. So it will be more Sprouts reflective. And we'll also be able to give better content, personalization offers to our customers and partner with our vendor community to put the right type of promotions out there in order to offset some of these costs. So there is a nice opportunity as we look at the back half of the year, as we go to the white label and reunify that platform. Again as it relates to click and collect, we've got such a great in-store experience. If you go back and look at the people that do really well with click and collect today, it's generally some of those that don't. So click and collect for us, we would still anticipate it being table stakes over time. We are utilizing Instacart folks today to do the picking and execute that for us. But we'll give you guys more color at the back half of the year as it relates to the pace of rollout of click and collect. I want to go back and talk about home delivery because home delivery for us is -- the growth has been fantastic. And even though we're in just 200 stores and 70% coverage area today, back half of the year we'll be in 100% coverage area and the sequential sales growth is solid, over 50%, continues to accelerate, driven by a much stronger basket that we see in home delivery, closer to $80. And it's also being driven by our Net Promoter Score which is best-in-class for those on Instacart. So the app rating, 4.7, it's really about the execution. So between Net Promoter Score and the execution, we're seeing great success on the home delivery front.

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

Okay. That's very helpful. And then as we think about your comp guidance for the year, it sounded like the both size and the ranges there had a little bit to do with inflation, I guess the competitive environment too. But can you maybe just help us understand what you are seeing in inflation, particularly in produce which sounds like had -- from others had flipped to inflation? Just how the market is there and what you're seeing into the first quarter?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Kelly, it's Brad, I'll just start and I'll let Jim add on here. When we set our guidance range, really we're focused on 1.5% to 3% but sort of the midpoint of the range would reflect a neutral inflationary environment for the whole year. But we are starting to see a little bit of produce inflation because of some tightness in some components of produce. And maybe Jim you want to comment on that.

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Yes, yes. So we would anticipate Q1 being slightly inflationary but again benign to full year. What we are seeing today is California and Mexico having some challenges with the weather out of Mexico, so the fruit side out of Northern California. There's nothing new to us in the first quarter. As you guys all know, you've been through this before with us, it's the most challenging and it has the biggest variability due to weather. But we'd anticipate that improving as we progress through the back half of the quarter and into the second quarter. So anticipating just a slight inflation driven by produce becoming slightly inflationary in the quarter and then, as I mentioned before, we are seeing some of those cost increases in the nonperishable department.

Operator

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

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

My question has been answered.

Operator

Our next question will come from the line of Edward Kelly with Wells Fargo.

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

Just a follow-up quickly on the comp in the guide. Can you just talk about how the cadence of the comp looks throughout the quarter? And then what are you seeing so far in Q1? And if Q1 is modestly inflationary, does that mean that you are above the midpoint of the guidance to date in Q1?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. We are not going to comment on where we are in the specific quarter. We're comfortable that we've got a broad enough range for the full year. And we went broader this year because quite frankly, if you look at the last couple of years where we tried to accurately predict what would happen with inflation/deflation in our business where 23% of your sales are in produce and very difficult to predict beyond 4 to 6 weeks. So we took a different approach and really wanted a broader range. But again, for the full year, we would be expecting to be around the midpoint, maybe slightly higher in that full year guidance range. And we'll have some variability, week-to-week, quarter-to-quarter, largely due to what happens in certain commodity markets.

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

And then just with the inflation that you're seeing so far, is there any issue at all with pass-through? And what are you seeing in competition on that front?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

As it relates to the -- as I said before on the nonperishable side, the freight increases that we're seeing, we're starting to see retailers pass those through. Again there's a bit of a lag. But some of the produce inflation you're seeing is just -- it's tight markets related to weather. And so those don't go up 1%, 2%, 3%. Some of those will go up 40%. So obviously, retailers are passing through those dollar for dollar. But they're very short windows of time. So we're seeing stuff being passed through as it relates to produce and the tightness we're seeing in the veg coming out of Mexico and some of the fruit is just putting tightness, giving you the inability to promote on some of the key items that you'd like to.

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

And then just taking a step back real quick here. About a year ago, we were sort of thinking about 2019, I think you were asked on this call around returning to a more normal growth algorithm. And at that time, it was something that was in the cards. Meeting the next sort of tax and most of it -- the algorithm this year is still going to be below what I think would be normal. I guess, how are you thinking about how things have evolved and why you're still below that, I guess? And then what's the time frame look like in terms of you getting to a more normal algorithm again?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. It's Brad. In terms of the conversations that we've had, both with investors and internally around very important fresh item management implementation, we pushed out a little bit beyond what our original timing expectations were, and that's because we've had some great learnings as we started to roll the system out into bakery and then into meat. And so we didn't want to rush the implementation. It's too critically important to ensure we get the scalability and the efficiency throughout the organization across the store network. And so that pushes later into 2019. Also, there's a number of other, I think, very important initiatives that are going to drive long-term efficiency and connect us with our customers in a more meaningful way. Jim alluded to it earlier in terms of all the work that we're doing around digital, loyalty, customer, personalization. And so there's more cost in 2019 associated with standing that up. But that's going to put us in a very good place as we look beyond 2019. I'd say the last area of systems investments, just from a pure foundational perspective, is we are going live with Workday Financials. It's been a pretty significant undertaking and we're going live in the second quarter of this year which is going to give us tremendous scalability for the organization going forward. So if we step back and you look through all of the 700 basis points swings in tax rate, beyond 2019 and into '20, we'll have a lot of the step-up, quite frankly, in the dollar spend on these strategic initiatives will flat line, which we'll then be able -- we will be able to scale and drive some leverage beyond 2019. So I think we step back as a management team and look at -- we're playing the long game here and there's some critical investments in infrastructure and technology that are really going to take us to the next level in terms of where we are from a scalability, efficiency and with our customer. And so we believe strongly in the long-term algorithm that this is an ongoing double-digit EPS growth once we get through '19 and through the first half of '20.

Operator

And our next question comes from the line of Ken Goldman with JPMorgan.

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

You mentioned that a store would not be renewed. I don't want to make too big a deal out of it. But you are -- you did close 2 stores this past quarter. Could you help us out and tell us which part of the country is it or if it's public, which store is it? I'm just trying to figure out what the risk is really to the Southeast not working as well as you had hoped, just given that, that's one of the concern on the stock right now.

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Ken, it's Jim Nielsen. The 2 stores were in the Southeast. But I would want to back up and say that the Southeast is performing in line with our expectations. So it's driving our overall comp in Georgia as well as Alabama. Those were decisions we made -- we opened 170 stores in roughly 7 years. So some of the process that we had in terms of real estate selection, some of the tempo in which we went into a market has changed dramatically over time, some great learnings as we entered the line-up. We went in probably too quickly. But those were just really good real estate or bad real estate decisions and the right decision today to take them out of the marketplace. So nothing wrong with the markets, both contributing in line with expectations and providing a tailwind for us to our overall comp.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

So, Ken, I will just add that we haven't disclosed or announced the location of the lease which is an old location. Because we haven't disclosed it, we wouldn't want to give the specific location. But the context is, this was associated with an acquisition from years and years ago. And at the time of the acquisition, the store was essentially on top, a very close proximity to an existing Sprouts location. So at the end of the -- in fact, 2 stores close by. So at the end of the day, we just rented out, from an economic standpoint, it made sense. So there's really consolidation play. So there's nothing systemic here whatsoever.

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

Okay. So I guess for my follow-up, it will be a true follow-up on that one is which is should we be expecting, as years go forward here, that we really shouldn't see more than 1 or 2 maybe 3 store closings a year? I'm just trying to get a sense of that because it is one of the bear thesis in the stock is that hey, maybe these guys are doing a deeper review of which stores are functioning well and which stores are not. I'm just trying to get a sense for your thoughts there.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. So I would say there's been no change whatever in the company's ongoing review of performance assessment of the stores across the network. We had line of sight certainly on this new renewal that has come up and had plans for the last couple of years to not exercise. I think what we anchor on is the fact that we used to be 70-30 in terms of percentage of stores opening in existing versus new markets. And based on the performance that we've seen now a couple of years in a row of low 80s new store productivity, which is above our historical model of 75%, has really given us the confidence of accelerating that growth in new markets, and important long-term growth markets for us of scale is in the mid-Atlantic and Florida. And we see a great performance there. So I think we're feeling very bullish. The brand awareness is really resonating and improving as we get more and more stores opening up in Florida and the mid-Atlantic. So we're feeling really well about the long-term prospects for growth.

Operator

Our next question comes from the line of Chris Mandeville with Jefferies.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

On the comps, can I just ask how did the transition to Instacart influence numbers for the quarter? Maybe help us understand how that contributes to your guide for 2019? And then is there anything in terms of holiday shifts that we need to keep in mind for the first half of 2019?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Chris, it's Jim Nielsen. As far as the tailwind from the Instacart to home delivery, as we mentioned, we like the trajectory. It's not a material -- again, it's not a significant part of our business today. The top line growth rate is significant and we like the trajectory. We like some of the additions we're going to be able to add here with the unified platform on the back half of the year. But it wasn't a material add to the overall comp.

Christopher Mandeville - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then just a follow-up here, if I could. Brad, can you be more specific just with respect to what deflation was in Q4? When I think about the year-on-year comparison as we go through 2019 on the inflation front, it would seem to suggest kind of -- or maybe if you could help me think about the breakdown, is it fair to assume that the flip to flat to maybe modest benign inflation contributes maybe 1 to 1.5 points to the comp with the remainder coming from just maybe contribution of Instacart as well as traffic and mix?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. So starting with the fourth quarter, we saw a little bit less deflation. We are around, from a cost point of view, about 100 basis points, which was slightly better than our full year deflation which was slightly above 1%. What was baked into the midpoint to our comp guidance is assuming a neutral environment. And as Jim said, we're seeing a little bit of inflationary pressures in a few produce categories, which is driving some tightness in availability and as we witnessed in the fourth quarter, a little bit of a margin squeeze with regards to produce on those tight items. But our expectation in terms of flow is we'll get a bit of more inflation in the back half of the year. But again, we really wanted to come out with sort of a neutral call on inflation/deflation because we're so heavily skewed from a produce standpoint, very difficult to predict. But in the context of year-over-year, we don't see a significant move in cost from an overall total company point of view.

Operator

Our next question comes from the line of Paul Trussell with Deutsche Bank.

Paul Trussell - *Deutsche Bank AG, Research Division - Research Analyst*

You obviously, outlined some expense pressures from training and technology investments over the next 12 to 18 months and before we turn back to that kind of double-digit earnings algorithm. Just if you can help us understand what the comp threshold will be? Or how to think about what's needed to leverage SG&A? And then somewhat related to that, obviously, you've been embarking on a number of initiatives, deli, meat solutions, the fresh squeezed juice, et cetera. And I think early in the call, you mentioned that the offerings are now in over half of the stores. What's the performance difference in that group of stores versus the balance? And what -- how should we think about the future rollout into your latest customer-centric prototype?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Sure. Thanks, Paul. So from a leverage standpoint with regards to SG&A, we're around 3% as we continue to invest in these important scaling solutions. Obviously, our core identical stores are leveraged at well below that 3%. And when we think about it in the context over the next couple of years and look back through 2017, we've really significantly increased our investment dollars to enable us to grow in scale. However, when we look at the dollars that we're spending in 2019, which is 7 to 8 basis points step-up from the prior year, as we look forward into 2020 and beyond, yes, we'll still have investment, but I would say it's more of a flat dollar amount of investment, sort of a run rate going forward, which as your base changes, should enable us to start leveraging at a lower comp. Plus, as we have grown out into these new markets, mid-Atlantic and Florida, we've really scaled up the operational field team to be able to service and execute really well into these new markets. And so that, as we densify in those markets, it's going to allow us to get some leverage. From a deli point of view, we're extremely pleased. Yes, we have about 50% of our stores who have that expanded offering. We are seeing a marked improvement in deli sales comps in those stores that have all the elements compared to those that do not. And I'd say what we are most excited about is the new enhanced prototype that we'll roll out in 8 additional stores in 2019. And the stores that we have in place in this new enhanced proto really takes the customer experience and the presentation of the deli and meat and seafood to an entire new level of experience that has really resonated with the customer, and we're seeing marked increases in the dollar and penetration spend, both in deli and meat and seafood. So our full expectation is that, that becomes our proto that's in every single store beyond 2020, and we're really excited about the results to date because it really puts us on trend with today's consumer in terms of meal solutions at lunchtime and dinnertime and allows us to cater to a much younger millennial population which we haven't historically overindexed in.

Operator

Our next question comes from the line of Andrew Wolf with Loop Capital Markets.

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

Brad, sort of a follow-up to what you were just talking about on the new markets. I was wondering if you would comment on just either certain new markets or in aggregate. Are you seeing operating margin leverage in those markets, I think as you called it as they sort of densify? And what I'm getting at is the idea of the growth algorithm and you're basically putting it out there that mainly the deleveraging is coming from technology investments. Are your new markets giving you leverage in the sense that the margins are improving as you add more stores to leverage the scale?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Sure. Thanks, Andrew. When we look at markets that we entered 3 years ago, we -- I think that we had some challenges as we went into Georgia. I think the team has done a fantastic job from an operational and merchandising standpoint, improving our go-to-market offering day in, day out, and we are seeing a nice maturation not only in comps but margin as well. In terms of margin pressure as we go into new markets that are large opportunities for us in terms of Florida and the mid-Atlantic, until you densify, you do have deleverage on advertising costs and operational costs. What we've seen from the beginning of entry into Florida to where we are now and why we're opening so many stores in Florida this year, we're very excited about the trend that we're seeing. So yes, over time, we're going to be -- as we densify, we will definitely see EBITDA leverage coming in those new stores. And eventually, we'll have densified areas like the mid-Atlantic where we can put in a new 3PL DC to service those stores which will obviously, take pressure off the longer hauls that we are doing today until we get the requisite number of stores to open that DC.

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

Got it. That helps. Just a quick follow-up is unrelated to this question, it's more of a housekeeping. Can you quantify how much the workers' comp coming in well helped the quarter as well as, I guess, the State of California lowering its insurance payroll tax?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Sure. That was about $0.01 in the quarter.

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

And does any of that go forward, like the payroll tax?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. So it was a onetime benefit because we've had that extra payroll tax for the last few years. And so then it would be apples-to-apples from 2018 to 2019. At least our expectation is that California remains on site and we wouldn't see that return to the extra unemployment tax. So that will be a neutral year-over-year from an '18 to '19 point of view. But it was a win in '18 over '17.

Operator

Our next question comes from the line of Mark Carden with UBS.

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

So building a bit on the comp guidance on long-term algorithm questions. Can you guys talk a bit about why you elected not to go higher on your same-store sales outlook? I mean, you guys have historically talked about this being a 3 to 5 business and a 0 to 2 inflation environment. Is this mainly reflective of some conservatism around produce or have growth prospects fundamentally changed?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Thanks, Mark. I think if we reflect back on 2018, our original guidance then contemplated some inflation in cost. And obviously that didn't play out, and we've really just sat back and said, look, it's really too difficult to try and predict. So we think it's more prudent to give a comp guidance range where the midpoint of the range would assume a 0 inflationary environment. And so we could take you higher 2 to 3 or maybe higher would be an inflationary environment whereby the competitive environment is such that you're able to pass that through. As Jim commented, when we saw some initial inflation or reduced deflation in the fourth quarter, that did put a bit of a squeeze on because it's always customary that there's some temporary squeeze. So I think we'd rather be prudent in the guidance that we give and have a sufficient range that we take into account any swings in inflation/deflation.

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

Okay, great. And you guys seemed to have been having some good success with your new store prototype. Is there ability to accelerate pre-prototype sales and attract more millennial shoppers cause you to rethink your future store placement strategy beyond just spacing the stores further apart? For example, as you expand in more densely populated mid-Atlantic markets, could we see more stores opening in urban areas?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Yes. Actually, the new prototype, it does attract more millennial consumer. And when you think of the suburban versus urban, it gives us a great opportunity to perform much better in an urban environment. We've got 2 of those locations. We've done 5 total. 2 are in what you would deem to be an urban environment and they're performing extremely well. So yes, it kind of -- it opens up more trade areas with that prototype specifically in urban markets.

Operator

Our next question comes from the line of Karen Short with Barclays.

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

I'm just curious because this wasn't mentioned. But wondering if you could just give a little update on the time line on the executive search and/or thoughts with respect to internal candidates?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Karen, it's Brad. As we said on the last call after -- I guess it was in November, the board has embarked on the search externally and internal and has engaged a top-notch external firm to conduct the search. And so as we said before, it typically takes a range of 6 to 9 months. In the meantime, Jim and I are just keeping our heads down and working together and running the business and keeping us on track absolutely on our strategic priorities. So when we have an update, you'll hear.

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

Okay. And then just in terms of modeling I guess in general, wondering if you could just talk a little bit about the new store productivity on new prototypes? And then thinking forward, how that may kind of impact the comp waterfall? And then just on the model in general, can you just give a little color on how interest expense and rents may change as we go forward like fiscal '20 and beyond? Because I think both of those are going to be adjusted on an annual basis, so just any directional commentary would be helpful.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Sure. Certainly the new store productivity has accelerated from our historical model of 75% to the low 80s over the last couple of years. Too early to tell on impact of the comp waterfall for the new prototype because it's so young out there. But what we are seeing is both a very nice incremental lift in sales, particularly in meat, seafood, deli, also in bakery and an enhanced margin. So I think we are very bullish around the long-term prospects of how this will enhance the overall financial returns. And at the same time, certainly it's resonating across all of our demographics. But importantly, we are really attracting in these new locations a much more of a millennial crowd which is critically important for us. With regards to your interest expense question, was that to do with the lease accounting? I just want to clarify.

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

Yes.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

So 2 points maybe on interest expense. So as we mentioned, $11 million reduction in interest expense associated with those 45 financing leases from 2018 to 2019. If your question was more around interest expense as a whole for the company, our guidance is around $21 million this year and that includes about $1 million of amortization of the facility fees. We have roughly -- I think it's $250 million of debt that was hedged out, swapped out. And so our weighted average interest rate for this year would be roughly 3.8%. So we think we're well positioned. We expect to be -- 50% to 60% of our total net debt is swapped out in a 5-year arrangement.

Operator

Our next question comes from the line of Chris Prykull with Goldman Sachs.

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

I just wanted to clarify a comment that you made earlier I think in response to Ed's question, that you wouldn't expect a more normalized EPS growth rate algo until the back half of 2020. I guess why the ongoing pressure on that algo again in the first half? And then sort of as a follow-up, if you were to roll out click-and-collect more aggressively across the store base, like most of your peers already have, will that be margin-dilutive?

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Yes. So just in terms of the algorithm, again, we're not finishing fresh item management until the end of the third quarter of 2019. And like any other pretty significant change management system implementation, you learn how to optimize that system over a period of time. Also, we'll be completing a lot of work on the updated digital customer loyalty initiative from a system standpoint in the back half of '19 and into '20. So I think when we look at total dollars spend in 2019, we'll be very equal to what we expect to spend in 2020. So I think at this point, we'd rather just sit back and be, I think, prudent in terms of our expectations on specific timing in which we return to double-digit EPS growth as we move through a number of these system implementations. And as we -- this is a big year in 2019 where we move from 70% of the new stores in existing markets to 50% in new. And that puts, as I said, pressure on advertising, deleverage in those markets and operational team. So I think from a long-term point of view, we are very bullish around our prospects of growing this company high-growth and we're still growing 9% unit growth and we see many more years of that. And these systems are just critically important from a foundational perspective and will really put us at a new level in terms of engagement with our consumers from a digital point of view. So as we said earlier, we're playing for the long term, and I think it's important that we don't get off of these investments. But yes, so that's what underpin the timing.

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Chris, this is Jim. Just to follow up on your click-and-collect question, is it margin-dilutive. We're really early in the process to -- it's too early to tell whether it's margin-dilutive or not. As I said, as we get more data behind it and get more consumer response not only quantitative but also qualitative, we will give you guys more feedback in the calls upcoming. I would say that home delivery for us, as Brad mentioned, today is not margin-dilutive simply because of the providing the tailwind to comp and then the small pickup in gross margin that we see with that customer today. So...

Christopher Prykull - *Goldman Sachs Group Inc., Research Division - Equity Analyst*

Great. That's really helpful color. And then if could just squeeze one more in, I know we're past the hour. On freight cost, I guess how much -- what did you see in 2018? How much is the trucking market itself being a pressure? I mean, I know spot rates are down but contract rates are still up versus maybe just pressure from having to distribute to new markets versus existing markets. Just trying to understand why that would be an incremental pressure in '19 versus '18?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

Yes. Internally for the company, for our company, for our produce distribution, the deleverage is primarily coming from the miles to service the new geographies. So it's primarily that with some small freight cost increases that were contract-based. But the majority of it is just miles. As it relates to just the market, the market in general and the overall impact to cost of goods, across of chain of produce, obviously there's been some relief there in terms of the miles that are allowed to drive with the VLD. So there's been some relief on that and so we're not seeing a negative impact there. But on the nonperishable side, most of those are just a tail that are flowing through now. They hit the distributor in terms of cost increases a little bit earlier back half of the year and some of these things are just now flowing through at retail. There's a level of timing and notification that they had to give at retail before we would accept a price increase. So the market this year is going to be relatively stable and some of this is just a carryover from 2018.

Operator

And we have time for one further question. Our last question comes from the line of John Heinbockel with Guggenheim Securities.

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

So two quick things, guys. When you think about the maturation of fresh item management and the impact on the P&L, so I mean I guess the cost part of the training goes off first. But in terms of sales and shrink, the shrink improve -- when you think of those 2 pieces, which improves first? I guess the sales would improve the most. But the shrink come before sales or the other way around?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

John, it's Jim. The way we set it up organizationally because we are a sales-focused organization, is you kind of have to dial those estimates down in terms of your projections around minimum levels. And so we started with the idea of making sure that we optimize sales, so we're going to catch sales first and optimize kind of the shrink as kind of the secondary piece which we'll see happening throughout this year. So as we've gone and rolled out -- we've rolled up bakery, meat and deli -- as we rolled out the newer meat and deli, we're starting to see nice strong tailwinds from the FIM technology that are helping us drive sales. But the benefit of the shrink will be more, kind of, Q2 and then through Q4 as we optimize the on-hand levels.

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

And then lastly, you talked about the private-label penetration in basket. So when you think about what is in a loyal private-label shopper -- shopper's basket versus non, does that have any impact on their desire, willingness to shop the fresh part of the store? Is that more prominent in the basket of a loyal private-brand shopper or no?

James L. Nielsen - *Sprouts Farmers Market, Inc. - Interim Co-CEO, President & COO*

(inaudible) fresh department-specific. I mean, 95% of our customers shop produce. So I mean, regardless of those are private-label or not, it's pretty likely that they're going to be experiencing our fresh department. So private label is not the gateway to fresh. Fresh is providing that gateway for private label and I think the experience that we're providing in the taste and the innovation is what's really creating the tailwind in private label. We didn't launch that many new items this year. We're being very thoughtful around the process and making sure it's through innovation, making sure we got better content, better messaging, better team member adoption around the high level awareness so we can engage our team members. So our growth is coming. We talked about that 20-plus percent top line, 10% comp, nice growth in penetration, all coming from new baskets and more items in baskets, not item growth. it's very thoughtful growth. So we are 50, 150 a year products is what you'll see over the course of the next 3 years.

Operator

And that concludes today's question-and-answer session. I would now like to turn the call back to Mr. Brad Lukow for closing remarks.

Bradley S. Lukow - *Sprouts Farmers Market, Inc. - Interim Co-CEO, CFO & Treasurer*

Thank you very much. Jim and I would just like to extend our appreciation for everyone that joined us on the call today, and we look forward to seeing you over the next few weeks on the road.

Operator

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