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SFM - Q3 2019 Sprouts Farmers Market Inc Earnings Call

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OVERVIEW:

Co. reported 3Q19 net sales of $1.4b and diluted EPS of $0.22. Expects 2019 EPS to be $1.10-1.13. Expects 4Q19 net sales growth to be 6.5-7.5% and EPS to be $0.12-0.15.

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the Sprouts Farmers Market Third Quarter 2019 Earnings Conference 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 speaker today, Susannah Livingston, Investor Relations. Thank you, please go ahead, madam.

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 third quarter 2019 earnings call. Jack Sinclair, Chief Executive Officer; and Chip Molloy, Board Member and Interim Chief Financial Officer, are also on the call with me today.

The earnings release announcing our third quarter 2019 results 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.

With that, let me hand it over to Jack.

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

Thank you, Susannah, and good afternoon, everyone. Thank you for joining our call today.

I recently passed my 100th day here at Sprouts, and I'm even more excited now about the future of this company than I was 3 short months ago. Sprouts' unique offering from both the product and experience perspective has enormous potential for growth. We pioneered making healthy eating accessible to everyday grocery shoppers, and this trend is stronger today than ever before.

That said, we do have challenges to overcome. We must continue to stabilize the business in the near term, while also creating the platform to accelerate growth, profitable growth in the future.

Our results in the third quarter were slightly better than we expected, which Chip will speak to in a moment. I'm very pleased with how diligently the team is working towards improving the business, while at the same time focusing on the long-term potential growth of this brand.

After Chip is finished, I will return to provide more detail on how we're working towards our future. Chip?

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

Thanks, Jack, and good afternoon, everyone. I will begin by discussing our business during the third quarter and then review our guidance for the remainder of 2019.

For the third quarter, net sales were $1.4 billion, up 8% compared to the same period last year.

Comparable store sales increased 1.5%, traffic was down slightly, while basket was up. Our home delivery sales were up more than 200% this quarter, as customers adopt this added convenience.

A significant portion of our online business came from repeat customers. We also continue to learn from our click and collect test. Early results suggest that this service is not as attractive to our customers as home delivery.

For the third quarter, gross profit increased by 8% to $477 million, and our gross margin rate was 33.1%, a 25 basis point decline when compared to the same period last year.

Efforts to manage promotions to better balance traffic, sales and margins resulted in gross margins stabilizing in the back half of the quarter.

SG&A increased 12% to $404 million or 28.1% of sales compared to 27.3% in the same period last year. 35 basis points of this deleverage is from the adoption of the new lease accounting standard. The remaining deleverage is due to investments in new stores, expansion of our home delivery program and higher health care cost.

For the third quarter, our depreciation and amortization cost increased 12% to $31 million or 2.1% of sales, an increase of 5 basis points compared to the same period last year.

Store closure and other costs, mainly related to executive severance and hurricane preparedness were $2 million.

Our interest expense was $6 million, and our effective tax rate was 23% compared to 17% a year ago.

Third quarter diluted and adjusted diluted earnings per share was $0.22 compared to diluted EPS of $0.29 and adjusted diluted EPS of $0.27 in the same period last year.

As a reminder, the lease accounting standard will result in a net incremental expense of $0.04 per share for fiscal 2019 or $0.01 a quarter.

Shifting to the balance sheet and liquidity, we continue to utilize our strong operating cash flow from operations, $323 million year-to-date, to support our unit growth and sales initiatives. So far, we have invested $130 million in capital expenditures net of landlord reimbursement, primarily for new stores.

During the third quarter, we opened 9 new stores, resulting in 335 stores in 21 states. We remain on track to open 28 stores in 2019. We ended the quarter with $80 million in cash and cash equivalents, $515 million borrowed on our $700 million revolving credit facility, $55 million available under our current share repurchase authorizations and a net debt-to-EBITDA ratio of 1.4x. Year-to-date, we have repurchased 7.3 million shares for a total investment of $163 million.

Now let me turn to guidance for the remainder of 2019. For the fourth quarter, we expect net sales to grow 6.5% to 7.5%, with comps in the 0% to 1% range. Gross margin should be flat to slightly negative when compared to the fourth quarter of last year. We do expect to be more selective with promotions than we were last year.

For the fourth quarter, earnings per share is expected to be between $0.12 and $0.15, and for 2019 fiscal year between $1.10 and $1.13.

We expect our 2019 CapEx spend to be between $150 million to $160 million net of landlord reimbursement.

We have seen sequential progress during the quarter. That said, there is work to be done developing the platform of people, process and infrastructure so that we can sell -- can accelerate the expansion of our brand. This will take some time. However, we are confident, more than ever, that we're moving in the right direction.

Let me now turn it over to Jack.

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

Thanks, Chip. In the last 100 days, I had focused on visiting many of our markets and stores, speaking with our customers and team members. I visited distribution centers, met with vendors and worked with our leadership team to gain a deeper understanding of what is working and where we have opportunities for improvement.

As I indicated in my opening remarks, I am encouraged by our 30,000 team members' commitment to our mission and dedication to improve the business.

I believe more every day that we can significantly expand our brand and do so profitably. At all levels in our business, we have the advantage of team members who are experts in the industry and passionate about both the products we sell as well as the customers they serve.

We're engaging enterprise-wide with the team who interact with our customers every day by encouraging all 30,000 team members to contribute to improving our business.

We've introduced some new processes to capture these ideas, and I'm excited already about some of the potential outcomes.

Our format is unique in terms of product offering, department or categories and how we differentiate ourselves with stores that feature clear sightlines across the store.

I'm delighted to see that our offering is differentiated, relevant and the assortment has depth in many categories like grocery, frozen, dairy and produce. Our private label focus continues to grow with significant future expansion available.

All these come together with our small store -- small-scale store layout to create a trust in our brand that is hard to come by in today's environment.

What truly amazes me is the love our customers have for our brand, especially in markets where we have created density and awareness.

After 100 days, I'm firmly of belief that overcoming our challenges is within our own control. While the size of our store prototype has only increased slightly over the last few years, the cost to build has increased significantly. As we've drifted a bit from the core elements of how we best serve our customers, new stores have been increasingly more complicated and become more expensive to operate and build. Interestingly, our smaller stores tend to be more productive than our larger stores.

Our fresh shelf distribution works effectively, where we have density. Where we don't, it is suboptimal, which creates shrink in cost and efficiency. Going forward, the expansion of our store network and associated logistical support will be more coordinated and concentrated, driving efficiency in distribution and transportation.

On the marketing front, we spent a majority of our dollars on print advertising, which is an ineffective way to build our brand. Our current price and promotion strategy have led to margin instability. The Sprouts brand is differentiated and has real salience for both existing and potential customers, but we are not telling the brand story to the best of our ability.

Private label continues to be a great growth vehicle for sales, but we have multiple brand names under the Sprouts brand collection of products. We plan to build a cohesive private label brand, streamlining and improving our communication to customers that maximizes Sprouts' position as the affordable healthy living grocer.

We are diligently developing our longer-term strategy and well deleveraging external expertise to support us during this time. While we anticipate discussing our full strategy in more detail in early 2020, let me highlight a few key points today focused on our brand, unit growth and profitability.

We can build our brand, modify our store format and rebalance our pricing and promotions investments. There are so many great stories that we can bring to life as we transition our marketing spend towards more digital and less print. We have the opportunity to build one of the strongest grocery brands in United States by making healthy eating affordable to all through improved marketing efforts.

Our customers should know our product depth is far superior to our competitors. As an example, Sprouts frozen department carries one of the largest selections of dairy-free alternative ice creams I've ever seen.

In produce, offering speciality items allows us to decommodify this category. For a short period of time every year, we carry Cotton Candy Grapes literally bursting with real cotton candy flavor. And because of our strong produce partnerships, we always receive a disproportionate amount.

As we evaluate and potentially modify our store format, we're going to slightly slow growth to approximately 20 store openings in 2020. This selection will include stores that are already in flight and/or in premier locations.

Our expectation in 2021 is that we will return to or exceed our current rates of growth. We have confidence that with the optimal prototype, Sprouts has a long runway of unit growth ahead. A better balance of everyday low prices and promotions is important to the financial health of the business. This will take time.

While we experienced some early wins, these changes could lead to unevenness in comps as we cycle highly promotional periods. Overall, these changes will stabilize margins in the near term and create a stable and loyal customer base in the long term.

This is a new chapter for Sprouts, and I'm energized by the opportunities still to be implemented and convinced we can control our destiny. There is significant work to do as we move through these critical steps, and we're confident it will position us for longer-term profitable growth.

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

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from Paul Trussell from Deutsche Bank.

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

Just curious if you could give a little bit more detail on how you're going to approach new stores going forward, particularly in terms of some of the areas that you're looking at potentially modifying the geographies and where you're going to focus on building? And exactly what size box you're thinking about putting up?

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

Yes, thanks, Paul. I think, as I've gone around looking at the stores, particularly the new stores, that, I think, as I said in my remarks, the cost has crept up a little bit and it probably got a little bit too big. I think we can deliver the proposition in slightly smaller stores, but in terms of exactly what size is, we aren't at that point yet. We're working through some format work to get us in that place. So that's the kind of format side of it.

With regard to the geography, there's clearly been some inefficiencies in creating stores far away from our distribution center, which has created some cost inefficiencies as I sort of outlined in my remarks. And it also compromises our fresh farmers market position in certain stores as well. So we'll be looking at a more geographically concentrated store growth going forward once we get the format exactly the way we want to carry going forward.

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

And just as a follow-up, if you could talk a little bit more about how you're looking to manage promotions? Maybe talk about the competitive landscape as well as any actions you feel are needed in terms of retail pricing? And maybe kind of what you're seeing on the inflation, deflation front as a part of that gross margin conversation?

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

As we review the whole -- I think I indicated this in the last call that the balance of investment in high-low pricing and invest in everyday pricing got out of sync and we're trying to do both at the same time and that created, I think, some dilution in our comp sales and certainly had a detrimental effect in our margin over the last couple of years.

As we've looked to stabilize that, the first place we've looked at is the place where there's a lot of volatility and volatility in our produce depends a lot on how we source our produce and we've spent a lot of time trying to figure out what the right way to price our produce business is, which is such a big part of our operation. And we're finding ourselves to be in a very strong position competitively across the marketplace and not having to be quite as aggressive on price on our flyer program. So that's something that we continue to test new ways of attempting to figure out how to maximize our margins, while also not diluting the price position that we're in.

I'm not seeing across the competitive landscape anything that's worrying me in terms of what anyone is doing to make it more difficult for us to do that going forward. And when we look at our different categories, we're looking at different categories and trying to be surgical in terms of where we need to be in terms of our pricing to be at the value position that we want to be, which is the healthiest, best priced grocer in the marketplace. And there'll be more test we'll be doing over the next little while in different categories, where we may have to be more aggressive and in other categories where we may be able to be less aggressive in the future. So we're right in the middle of a number of tests on that, Paul.

Operator

Our next question comes from Judah Frommer from Crédit Suisse.

Judah C. Frommer - *Crédit Suisse AG, Research Division - Senior Analyst*

First, you did mention, I think chip mentioned, negative traffic in the comp. I was wondering if you could give us any color on the elasticity you saw from pulling back on promotion in the second half of the quarter? And how that makes you think about driving traffic across the banner longer term?

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

Judah, this is Chip. The traffic has been slightly negative throughout the year. And interesting for us, as we started to, for lack of a better expression, sort of unwind some of the aggressive promotions, we found that the traffic trends really didn't change. They didn't get worse, they didn't get better. But at the same time, we're able to pick up a little on the AUR side, which helps comps. And at the same time, we're able to start to stabilize margins. And as I said in the remarks, as we've got to the back half of the quarter, our margins were stable from a year-over-year perspective.

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

Yes, as we build forward, just to build on what Chip just said there, I think the way to drive traffic in the business is a lot about how we invest in our marketing dollars. We've got fairly okay marketing dollar budget in terms of what we go. But we spent a disproportionate amount of that on print. And I think what we've done some really little tests about trying to use digital and mobile in a more effective way and communicate more directly. The reason for coming to Sprouts. And I think ultimately those will be the determining factor as and when we get our traffic growing. And that's certainly, we're determined to get there. But in the short term, we're doing a number of tests as to how the best way to spend our dollars differently.

We sent 21 million paper flyers every week. So there's a lot of scope for us to take -- send a few less flyers and spend some money on different ways of driving traffic. And by market, we've got a number of tests that we've started and a number of tests that we're about to implement, which will give us some confidence as we go through next year that we can start to use our marketing dollars more effectively to drive traffic.

Judah C. Frommer - *Crédit Suisse AG, Research Division - Senior Analyst*

Okay. Great. And Jack, I think you mentioned kind of bringing in some external expertise and potentially bulking up the team and operationally needing kind of a more solid platform. Where have you seen Sprouts potentially lacking in terms of the infrastructure, be it operationally, real estate, supply chain or otherwise, that you maybe like to improve before you embark on getting back to kind of current levels of square footage growth?

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

As I said in the remarks, I'm really, really pleased by the spirit of the people in our stores. It's actually blown me away, the quality of the people, the interface with the customers that our managers have in -- right across the store, particularly in our vitamin supplement department, where we've got real expertise and I've been really pleased with that.

I think, behind the scenes, how do we create an infrastructure to be more effective at managing our inventory, to be more effective at managing our distribution flow and to be more effective at making life a little bit easier for our stores in terms of what we do here to support those stores. At the end, the life of the back of our stores has been something that I found very helpful to understand, the number of deliveries we've got coming in, the amount of inventory that's got coming in and the effectiveness of that is something that an infrastructure (inaudible) distribution and logistics departments will help that going forward.

And with regard to the external support we've got, that support is primarily going to help us with the strategic view going forward. And there is a bandwidth issue within our business and we've got a lot of very committed people. But in order to deal with some of the short-term things I have just talked about, we probably -- and we are -- we do need some external support to help us with the longer-term thinking here.

Operator

Our next question comes from Ken Goldman from JPMorgan.

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

Two questions for me, if I can. The first is, you mentioned -- I think the term you said was some unevenness in comps ahead as we cycle highly promotional periods. I know you're not giving guidance in the future, but it would help us for modeling purposes. Are there any quarters that stand out in the next 2 or 3 that we should -- we have to think about as maybe a difficult lap?

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

Ken, this is Chip. So as it relates to the quarters and the outlook, we're just now working through our budget for next year. So how that plays out into next year is to be determined. We gave guidance for the fourth quarter. The guidance for the fourth quarter is slightly lower than we just delivered in Q3, but if you look on a 2-year basis, it looks fairly similar.

So that's kind of how we're planning it. As it relates to next year, it's going to be a year that we work through, as we work through our strategy, as we work through -- as you've heard the stores are going to be in the 20-ish range as we prepare the infrastructure for the following year. But long term, I mean this is a business that if you want to build square footage long term, to be able to create an earnings growth environment, you have to do a 2.5% plus comp. And that's -- the goal for us is to get to a place where we're able to deliver the kind of comp with stable gross margins that creates a meaningful earnings growth, while you're still building square footage and that's going to take a little time. But for right now, as you get -- we gave you Q4, next year is probably going to look -- right now, we're working it out, probably won't look a whole heck of a lot different than this year. As we get into '21, that's what we're really focused.

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

Sorry, I missed what you said wouldn't look that different next year, I apologize.

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

Full year next year, we're still working it out, but I don't think it will look much different than this year from a total comp perspective, I wouldn't expect it to.

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

Okay, that's helpful. And then, I guess, I'll follow up with another question about next year, and I'm sure that's not what you want to answer, but I'll try anyway. The -- so you have talked about a couple of headwinds and tailwinds and things that you won't get to a 2.5% comp, and so forth. But I think the big missing piece for me and maybe some other people on the call is, how much you need to spend to get back on the business, right? Whether it's capital spending, operating expenditure, systems? I guess, what people are trying to figure really is, "Okay, if the comp is similar next year, are we looking at a much more difficult overall EBITDA margin because of these investments?" Or is it something where you feel like, "You know what, no, it's little minor tweaks maybe here and there and next year will still be an investment year, but it won't be as big as feared perhaps?"

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

I'll start with the capital side. The capital side clearly will probably be with just only 20 stores, you just saw us reduce our CapEx for the projection for this year, full year, and that's because of the less capital we're putting out right now for stores that should be opening next year.

So my expectation on the capital front, next year shouldn't if anything it will go down and then if we decide in '21 and beyond to grow faster or with more stores, you think about part of what we're doing here is just try to reduce the cost to build. Our stores have gone up over 40% in cost to build in the last 4 years, and we have a strong belief that there is a lot of that cost that we can eliminate and build our stores less expensively. So therefore, I don't see capital ever really getting higher than $150 million to, call it, $200 million in the next several years for that new stores, whether it be DCs, whether it be infrastructure. We probably will build some more DCs because we want to be much more effective and efficient as it relates to operating those stores. But I just don't see the capital getting -- going any higher than what I just said over the next several years. On the operating expense side, we're going to get to a place -- yes, we'll have initiatives, but we're going to do that in the confines of -- we can only grow expenses so much to at least in a stable gross margin environment to create some sort of acceptable earnings growth. And so we have control over that. And I think we're working towards the puts and takes right now that we'll get it to a place where we hopefully won't get deleverage, but we think we can at least get flat to some leverage over the course of the next couple of years.

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

Sorry, the big determining factor on that is Chip's point on stabilizing our margins, which we feel confident we can do.

Operator

Our next question comes from John Heinbockel from Guggenheim Securities.

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

So 2 questions. Number 1, what do you think -- what mature store comp will be embedded in the 2.5% overall comp. And is the bigger opportunity? Because you talked about customers that are passionate, who know what the brand stands for. Is the bigger opportunity noncustomers getting a better appreciation for what you stand for? Number 1. Then number 2, it sounds like click and collect probably does not get expanded from here, that kind of dies and the focus will we on home delivery.

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

I'll go -- a couple of things. Well, I'll talk to both and Jack can jump in. From a brand perspective, we believe there's a tremendous opportunity from a brand reach perspective. Customers that -- potential customers that don't know us today. Those are -- how we're going to reach them? More effective marketing in the markets we are in and the markets we are going to, but also entering new markets and doing it in a more concentrated way. And we can start to put more marketing dollars in those markets and leverage that. We can get more word of mouth. We can talk more on radio. We can talk more in whatever medium we can. So there is brand reach opportunities here in existing markets and in new markets, and you will get much more effective in the way we go to those new markets.

On the click and collect front, we're not going to stop click and collect. Customers are -- there is customers who are going to want that service. It doesn't cost us a lot of extra money to do that service. It hasn't taken -- we did 6x an average store that has click and collect versus an average store that has delivery, we do 6x on the delivery side than we do on click and collect right now, but we're still going to offer that service and we'll grow as the customer grows it.

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

Yes, so just to reinforce the message on brand awareness, John, the reality for me is that when we have such sporadic geography in our development -- in our new store program, it's very hard to get effective marketing communication. And the opportunity for awareness is very real and we can see that in the data. There's a lot of people just don't know who we are. And as you go to our market, 1 store at a time, it's harder to get that message over. Particularly, when you do it in a program of sending price down through flyers, it doesn't tell the message or the story of who we are. And I'm very, actually, excited about what that may drive towards in terms of additional traffic when we get it up and running and making working.

With regard to click and collect, I think our format don't lend themselves as much to that as some of the larger formats, some of the mass formats. Having said that, to Chip's point, we'll meet the customer where the customer wants to be met. I'll be fairly -- really interested about how people in places like the Bay Area have been accessing our delivery, people have been accessing the brand pretty effectively in certain stores and I'm intrigued by how we may develop that going forward in terms of, again, meeting the customer where they want to be met going forward.

Operator

Our next question comes from Karen Short from Barclays.

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

I wanted to just go back to the store opening comments. So for 2020 openings, I guess the first question is, do you have the ability to tweak the cost to build for the 2020 class? And then if so, what exactly do you think you'll be adjusting?

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

Well, in terms of the cost, there's some opportunity for us to improve the 2020 build costs, but not by as much as what we think it can be going forward in terms of making the store slightly smaller. So in terms of that opportunity, that would be the kind of -- that the cost per square foot can come down by making -- the total cost will come down as the cost per square foot -- as our square footage goes down. The cost per square foot can come down a little bit as we mature our sourcing effectively of some of the things we have put into our stores, our enhanced format stores. Does that answer your question, Karen?

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

Yes, and then I guess, just on that class of stores, so -- I mean I understand that you are not involved in the approval process of those locations. So can you maybe give a little color on what gives you confidence the locations are optimal?

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

Well, Karen, it's Chip. We've looked at all the stores that were in play for next year and those that we felt like really were on the fringe and we really would prefer from a supply chain perspective or a cost perspective, we've done our best to unwind those. The ones that are still on the list of what we believe are the better locations of the class and there are also -- in many cases, the ones that we think we have some control at this point to reduce the cost on those stores. So we're doing -- we're working a way through that class and trying to make it as effective as we can, recognizing that most of those, if not all of those, leases were signed. As it relates to 2021, our expectation is we'll get back to at least 30 a year, and we'll have a lot more control over those and we're just now -- we're not approving those yet until we really refine the way we want that prototype to look.

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

And the real estate team has done a really good job at developing these stores and getting over, but then maybe a strategy that we're going to change going forward. But -- and I think as they mature, the focus on how we cost down, I think we can make some short-term benefits as well.

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

Okay. And then just a question on pricing. I mean, obviously, you talked about high-low and EDLP. I just was wondering if you could give us some initial color and this is aside from high-low, EDLP, some thoughts on your pricing in nonperishables? Because, obviously, one of your primary competitors has been making progress on pricing, especially in like grocery, nonperishables. So just some early thoughts on where you stand on that and whether there's anything that needs to be adjusted there?

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

I think as you go through the whole nonperishable side of the business, the thing -- when we are successful, and you can see in our comps, is when we have very differentiated assortment. And then pricing becomes less of a sensitivity in terms of if you're selling things that nobody else is selling, you can actually manage it effectively as a value play. And when I look at categories, particularly somewhere like frozen foods where when I walk up and down our frozen cabinets, we've got a very different offer to what I would find in a traditional grocery store. And that allows us, I think, to get the kind of pricing that reflects what the customer sees as value as opposed to it reflects what our competitors are pricing something up.

And we found the same in our plant-based business. We found the same in our dairy business that when we've got real differentiation, the pricing hasn't got the same sensitivity as it might have in -- as when other grocers are comparing themselves with other grocers in that space. We're taking a good look at our vitamins and HBA business to see whether that's as competitive as we need it to be.

So there's a little bit of work going on that. But in rest of our nonperishables, I think we're in a pretty good place on pricing. And if we keep bringing innovation to the marketplace and keeping ahead of it, I'm pretty confident those categories are well priced.

Operator

Our next question comes from Scott Mushkin from R5 Capital.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

I'm sorry, I'm a little bit on the street here. So I guess my question is about the stores. I mean the idea of spending more and going to kind of a slightly lower larger box had to do with adding a lot of the stuff into those boxes, expanded deli as an example, some more food service. And I believe that was part of the reason the stores were coming out of the box pretty solid. So I guess I just wanted to understand a little bit more about the decision to maybe go to a smaller box with less of these services and how we -- how you're kind of thinking about because it seems like the company went away from the smaller box and added stuff and added stuff in because they -- the competition had gotten a little more fierce, particularly in the fresh area.

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

Yes. I think as I go around our newer, bigger stores with the enhanced deli proposition in it, the customers like them. They're just costing a little bit too much for us and are taking up a little bit too much space. And when I compare those stores to some of the stores that we have done and are smaller stores, as I think Chip had made in the remarks, our smaller stores actually carry as much for the customer in terms of what they can get. You could argue the experience is different because it's smaller. We've built an experiential improvement in our deli business in our enhanced stores.

But in terms of a farmers' market feel, the smaller stores create that farmers' market feel that we're trying to kind of replicate, and it's got the assortment and product offer that we wanted to have. So I think there's a middle ground to you in terms of where we get to. We don't know exactly how it's going to play out. But when you look at the cost per square foot, we need to find a way of not spending as much money. And I think we can get a lot more stores into 2021 and 2022 with an approach that makes them a little smaller.

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

And Scott, I would add, just think about the fact that if you make the stores more expensive, and yes, your enhancements do create a return. But the returns, yes, they do create shareholder value. But if you take the alternative approach and said what if, what if I can still present the customer -- the core customer value proposition and I can do it a lot less expensively and the returns on these individual sites are higher, it affords me the right to take more risk, go into markets more concentrated, create more brand awareness, et cetera.

So that's the lean. We still have work to do to get proven out. But we have stores today, as Jack pointed out, that are significantly smaller, create the same -- the core brand proposition and are incredibly productive. And so that's what leads us to at least a hypothesis and something that we need to work through.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Those are all older stores though, correct, the ones you're referring to with that productivity?

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

Most are older stores. That's true. And I'm not expecting to get the same kind of volume in those very established deep entrenched stores. But if I can get the same volume I'm getting today in a newer store and it costs me 40% less to get in there and I was getting basically the same volume, the returns are exponentially larger.

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Thanks for the long -- not long answer but the detailed answer. So my second question, my follow-up question goes to the delivery, the delivery business and how we should think about the economics of that as it grows. And then I'll yield.

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

You mean home delivery business, Scott?

THOMSON REUTERS

Scott Andrew Mushkin - *R5 Capital Ltd - Founder & CEO*

Yes, correct, correct.

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

Yes, yes. As I said to you, what we're finding is we're finding pockets of real customer interest in this. And it tends to be pockets, and it's not all -- right across the chain. And we need to understand that as we evolve and develop it. It clearly does cost us more -- the margin isn't as strong. And then there's ways that we can mitigate that negativity in terms of margin play. But as I said, we've got to meet the customer where the customer wants to be met. If we get this right experientially, our home delivery both -- in terms of in-store, our home delivery business will marry appropriately alongside it so that you've got people doing both things. And then if we can get that basket growth that comes from customers being committed to the Sprouts Brand, whether they're having to come to the store or having it delivered, I think we can melt the margin in such a way that we can manage it effectively. But we're doing a lot of work on that as we speak, and the external people are helping us on this, help us understand this a little bit better as well.

Operator

Our next question comes from Kelly Bania from BMO Capital.

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

Just wanted to ask a couple more on the stores and the decision to, it sounds like, more densely locate the stores. Maybe just an update on cannibalization, how that tracked this year and what it could look like in 2020 and beyond as you start to kind of more densely populate those stores.

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

Kelly, it's Chip. Cannibalization -- I'll start with this year. Cannibalization has been decreasing as a negative impact for us as a company. We've been very -- the company's been very focused on it. I think for us, as we've been focused on it, we haven't really thought about the bigger play here, which is if I could go attack a market and I could go attack it with 20 stores because the projected returns are a lot higher and I have supply chain, I have distribution center there to support it, the efficiency of the distribution center to help support it and the brand presentation because the distribution center is closer and you can do a lot more stores. We think that, that would be a better answer. I'm not suggesting -- I'm not suggesting we're there quite yet. What we're working towards is we think that will be a better answer and the need to worry about cannibalization is -- it just becomes something that we shouldn't worry about as much.

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

On the context of cannibalization for me, it comes to the conversation we've been having about brand awareness. Within each marketplace, if we can get a more dense store proposition, I do believe if we market it effectively and get awareness, even in markets where people know us, there's a lot of people that don't know we are and what we do. And I think there's an opportunity for us to really invest in marketing appropriately to drive awareness, to dilute the effect of cannibalization. And if you do smaller stores, you need less sales as well within that to make the economics work. So both of those things are the hypotheses or the theory that we got at the moment.

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

Okay. That's helpful. And then maybe just another one on the stores. With the 20 that you're expecting next year, should we expect that, that has some sort of modified deli component? Or that will still have the deli that we're used to seeing in the stores? And when we get back to -- when the plan -- target is to get back to 30 in 2021. Is there -- does that depend on where comps go next year or how this 20 stores performs? I'm just curious like what that is -- what kind of you're gauging to get back to that level of growth.

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

With the gestation period kind of stores, the 20 stores that we're doing next year are going to be by and large the same as the stores you've seen in the enhanced prototypes with the larger deli. And as I said, the customers like them. So I think that they'll perform well. Going forward, how can we replicate the experience the customers are getting without spending as much money in smaller stores would be the attempt that we're going to make and the format we're going to be doing over the next few months.

But the 2020 stores will work the same as the stores you've seen. We won't be able to change them even if we wanted to. I think we can do them a little cheaper simply because we've learned how to do it more effectively as the team that had been working on this have learned how to do it. Going forward, after 2021, I believe that we can go at least back to where we were in terms of the number of stores that we're building. I would actually hope that we'd be able to do more than that going forward.

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

And Kelly, I would also add, our confidence in getting back to the 30 isn't because -- it's there because we're not overly disappointed with the stores that we're building today. We just believe we could do it better. Worst-case scenario, we're building 30 in 2021 that look just like the ones we've been building. But we just have a belief that we can do it different and better.

And so we're going to work through that and then go out with that. But that's why we're confident we can get to at least 30. And if we can do it better and more cheaply and we can think it's more effective, we can build more than that.

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

That's helpful. If I could just ask maybe one more on just the pricing. I think for Sprouts histories, I'm aware they've talked about kind of 20% to 30% price gap versus traditional supermarket peers, in produce at least. And just with your comments so far, talking a little bit about that category and the front page ads, is that still the case that you're seeing when you're -- with your pricing analysis? Or where do you think Sprouts needs to be in order to get back to the comps that it's targeting?

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

By and large, we're still operating at 20% less on our produce business. And it's -- the more we can create differentiation though -- and I think we're going to invest a lot more people and resource in local sourcing so that in Colorado or Florida, we're actually much more effective at bringing local products and replicate what a farmers' market. I would think if we're going to be a farmers' market, we need to really source product on the ground locally more effectively than we are at the moment, and we're investing people behind that. And then it changes the whole price equation in terms of how you can work it.

But by and large, we're still 20% cheaper. The promotions are not quite as aggressive as they were. We're not seeing any effects on our traffic, and our margins are tweaking up a little bit. So I think we'll keep doing that for a little while and then see where it takes us.

Operator

Our next question comes from Edward Kelly from Wells Fargo.

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

So I wanted to ask you a question about new store returns and what's reasonable to target. So when you went public, as I remember correctly, you had a payback period of probably in the neighborhood of like 3.5 to 4 years. As we think about where things are today, I mean I can look at your EBITDA margin on that, and they're 300 basis points lower and the cost is 40% higher. So I'm just kind of curious, where is -- what do new store returns look like now? And then what's a reasonable target for us to think about if you decide that the new model works and that you would accelerate growth upon that?

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

Ed, honestly, I think it would be premature at this point to go through that level of detail. I would tell you that at some point, that is something that we would provide, but it's just too early for us to do that because we don't know -- we're all leaning in one direction, but what that finally looks like doesn't necessarily mean -- we don't want to assume that we're absolutely right, we're leaning in that duration as we've implied on the call. But give us a little time, give us a couple of quarters, and we'll get back to you on that one.

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

All right. And any thoughts on store closures as well as what all of this means to the East Coast strategy?

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

We're sorting through that as well. That's going to be an area of focus for us. It is really -- we have come to believe, as we should, supply chain and new stores have to go hand in hand. They have to. And so as we look across the country and we look for those areas of opportunity to build stores and we look for where we have stores today, we're going to be evaluating all of that. And it's critical for us to make sure that our supply chain, especially on the produce side, which we pretty much control all within our own house, it needs to be much more dense.

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

So shorter lines of distribution will lead us to focus on exactly where we build the stores. And the strategy of supply chain, logistics and new stores comes together pretty well.

But with regard to the East Coast comment, we're very excited about Florida going forward. We think there's some real opportunities in that market.

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

All right. One last one for you just on supply chain. Obviously, Sprouts has prided itself on value and produce. Selling prices over the years at retail obviously have come down. What's happened on the supply side though for Sprouts? What I mean is like what you're buying this product at. Has there been any negative impact by the fact that scale grows and the type of deals that you see are maybe different than what they were, right? The larger you get, you start to become more of a mainstream sort of sorcerer. And can you still price product at that discount to conventional? You see what I'm asking?

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

Yes, I see the question you're asking. And I think the reality of this -- I have been involved in this and all over the place over the years. The quality of your sourcing team and the thinking behind specifications is one of the things that allows you to be very appropriate and work well with the growing community. And one of the things -- we brought some new people into that space, and we'll bring some more people into that space. When you get the right relationship with the growers, you can manage this effectively.

There's a lot of volatility. And being on top of that volatility from one week to next, from one month to the next and from one geographic location to the next allows you to be very effective at having competitive prices in the right way going forward. And more and more, we will -- as you get to scale, it's about developing the type of relationships that build long-term, growing plans with your growers.

And I've been excited about the dialogue that we're having in that to not only keep our price position and our value position but bring differentiation in terms of the specifications, the things like larger blueberries or sweeter grapes or -- and getting into how you get varietal development in tomatoes and those kind of things. The teams are doing a nice job on that. And that will allow us to continue to have a differentiation and keep produce at the forefront of what a farmers' market needs to be.

Operator

Our next question comes from Mark Carden from UBS.

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

So you guys inherited a number of different initiatives. On ones that are already in place like Fresh Item management and Workday Financials, are you seeing the desired results thus far? And then even beyond the cost standpoint, given the sheer number of bids that were already in place when you guys fully took the keys, does it limit the degree of incremental change that you think you can make next year?

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

Mark, it's Chip. We're happy with FIM and we're happy with Workday. We've gotten through those. And we're getting some of the benefits from FIM, many of which we thought we were going to get, and those are showing up. Workday is a better way to work. And we went through a massive, call it, ERP for that. And we're on the other side of it, we're getting benefits there as well. So we're very pleased with that as it relates to going forward.

What was the second part of your question? I apologize.

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

Just in terms of the added degree of complexity of the [FML], does it limit what you can do next year.

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

No. I don't think it limits what we can do next year. You've already heard some of the -- there are other limitations next year, sure. As it relates to, okay, were already in flight on a bunch of stores. So how do we make that? Are there other things we're in flight on? Absolutely. But none of those that really, I don't think, tie our hands or limit us. And I don't see any restrictions.

It is going to take a little time. I think the pricing and promotions, and as Jack has alluded to, working our way through that and doing it right without burning the house down, we want to make sure that, that never happens. And so we're working -- for lack of a better term, we're unwinding a little bit of the very, very aggressive pricing promotions on top of promotions on top of promotions, which we're not getting credit for from a traffic perspective or even a sales perspective.

So we're being very careful about that. But that's probably the most difficult thing to work your way through with the difficult nature associated with what the outcome of that is going to be. So that's why we're doing a lot of testing.

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

And to me, there's nothing in flight that I'm worried that we cannot do it if we don't want to do it. The biggest thing that I've been pleased about is the mindset of the team to try different things. So they're not weighted to a mindset where we were at, and that's been very encouraging with the merchants and the operators and the team. And that's going to make it easier for us to make changes going forward.

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

Great. That's helpful. And then another question on delivery. One of your larger competitors recently announced it was eliminating fees. Does this make you rethink your own grocery delivery and grocery pickup fee structure? Or do you think that the overall value proposition still allow you to gain share?

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

Yes. I think, obviously, we watch what competitors are doing all the time. But I'm a big believer that if a retailer knows what it wants to be, we should stick to being good at what we are. We watch what the competitors are doing. Our differentiation in terms of the product assortment that we have, in terms of what we do in bulk, in terms of the advice we give in vitamins, in terms of the clarity that we have around our plant-based initiatives, the clarity that we have around our vegan initiative, those kind of initiatives create a differentiation that means people -- we want people and we think people will migrate to the Sprouts brand irrespective of that particular initiative. It doesn't over-concern me.

Operator

Our last question comes from Chuck Grom from Gordon Haskett.

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

Just a couple for me. Earlier in the year, you ran into some produce issues. As you sit here today, just how are you thinking about produce, particularly given some of the issues in California? And then just the second is on the comps. When you think about the 1.5% that you delivered here in the third quarter, I'm curious how big a dispersion exists between older stores and new stores. And I guess I'll let you define old versus new.

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

Chuck, I think Jack will answer the first part, and I'll answer the second part.

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

Okay. So with regard to produce, the dynamic changes all the time in that from 1 week to the next, from one growing region to the next. And if you can get produce in one place, you can get produce in other place. And the reality of it is it's about the talent and the expertise and the team. And as I've said a couple of times now, bringing new people on board, sourcing more effectively locally, sourcing within our -- so if you think of the places we're operating in, Florida has got a very different dynamic to California. Colorado has got a very different dynamic to California. Arizona has got a different dynamic. So the opportunity is there for us to be effective from 1 week to the next or 1 month to the next if we've got the right people in place. And as I said, I've been pleased with the way that's been working in the last little while.

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

Yes. Chuck, as far as the comps, I mean, really the vintage comps, while we're comping at 1.5 and you're doing to 200% growth on your delivery and you would hope that your newer vintages are comping year-over-year, you would get to a place, I would say, your oldest vintages are negative. And that's a true statement. They are -- but it's only slight. So it's not -- there's nothing really bad. Our 2015 [and priors are] slightly negative, but all of our newer vintages are positive, and our delivery is extremely positive.

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

And just as a follow-up, can you just remind us what the penetration is on delivery? So we can just back into what the comp benefit helped you here in the quarter.

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

3%.

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

I think it's 3%, yes.

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

It's about 3%, yes. We're doing about -- we're doing just over 3 million a week now.

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

And it's growing up. It's growing up. Close to 200%. We're growing up.

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

Right. And I guess just a follow-up. There's been Walmart and target success on click and collect. It's been very well documented. It's really supporting their comps. Just curious why do you think it's not being adopted by your customer as much just because it seems to be working there so well.

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

I actually think the format lends itself better, too, like I said. I think just a larger mass store gives more space for them to execute that effectively. But it's early days for us. We haven't really marketed it. We'll see what happens over the next little while. We haven't abandoned it. As I said, if the customer wants to do it that way, we'll do it that way. But our store setup isn't as easy to do when you get a smaller box.

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

Also, when you think about it, we're not a full shop. So we're sort of a destination for those unique and differentiated items. And we're also not the kind of place that you're going to go for just the basics of the basics. You're not going to buy the -- you're not going to buy a lot of floor cleaner. You're not going to buy cleaning supplies or detergent, et cetera. So when you think about that, I would -- it doesn't make -- it makes some sense as to why click and collect is just not -- is not as attractive to our customers as it may be for some of the others.

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

Yes. I think we get our brand right. There's a treasure hunt element to our business that's different to the consumable element it -- does lend itself to click and collect more effectively.

Operator

This concludes the Q&A session. At this time, I'd like to turn the call over to Jack Sinclair, CEO, for closing remarks.

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

Yes. Thanks very much, guys, for spending time listening to us today. We really appreciate your interest in our business. And I look forward to updating you in the future calls. Thanks very much.

Operator

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