Sprouts Farmers Market

Client Report

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Executive Summary

DangerZone has identified four areas in which Sprouts ought to make strategic improvements: (1) keeping customer loyalty high, (2) increasing efficiency across all stores, (3) expanding to viable areas, and (4) further establishing the Sprouts brand.

(1) Developing a customer loyalty program that stores customer information and provides discounts for members will establish firm customer loyalty. Loyalty increases buyer switching costs, which will prevent Sprouts from losing revenue to its competition. Furthermore, studies have shown that increased loyalty leads to more frequent trips to the store and more money spent per trip.

(2) Creating a mobile app that stores member information will increase customer loyalty and improve efficiency, as inventory will be easier to manage effectively. Sprouts' method of operating with a low gross margin by design makes a boost in asset turnover a key goal for the company, as this will be the main driver of revenue. Efficiency gains result in faster turnover, as products are moved in and out of shelves more quickly.

(3) Sprouts has solid financial ratios that are in line with what we expect from an expanding company, demonstrating good liquidity and solvency that can support further growth. However, overexpansion can result in huge losses, so the areas and methods of expansion must be reviewed closely. We recommend that Sprouts reconsider its planned expansion into the Southeast, keeping a move into the Northwest in mind as an alternative.

(4) Heightening its social media presence and increasing the transparency of the origin of location of its products will help entrench Sprouts in the mind of consumers in the grocery market. Market differentiation is key for Sprouts due to the market being crowded with well-established players. By continuing to build strong relationships with growers, Sprouts can ensure a stable supply during its growth period and keep prices lower than many of its competitors, which helps differentiate its brand. The expansion on Trader Joe's, along with larger grocers like Safeway and Kroger's beginning to offer more organic, all-natural options, directly threaten

Sprouts' profitability. This results in a more competitive environment that requires a strong brand and focused strategy for the future, with little room for error. By continuing most of its current practices and taking our suggestions into consideration, DangerZone believes that Sprouts will continue to increase profitability and have a stable, healthy future.

Company Background

Sprouts Farmers Market is a chain of specialty grocery stores focusing on affordable natural foods, fresh produce and dietary supplements. Headquartered in Phoenix, Sprouts currently operates over 170 stores in 9 states: Arizona, California, Colorado, Nevada, New Mexico, Oklahoma, Texas, Utah and Kansas. Sprouts emphasizes its "farmers market" quality of fresh foods from local sources and hopes to capture a significant market share of the growing demand for healthy, natural foods. In fiscal 2013, Sprouts increased its net sales by 35.8% and net income by 163.2%, partially due to its 19 new locations that opened during the year. The company's rapid expansion has convinced investors to voice a largely optimistic view about the future of Sprouts.

Sprouts was founded on the smallest local level and has maintained aspects of this essence through its evolution and expansion into the multi-state chain it is today. Through a series of acquisitions, Sprouts has emerged as a growing company that is carving a niche for itself in the grocery store market.

History

In 1934, Henry Boney journeyed from his hometown of Kress, Texas to California in response to the Dust Bowl. Soon, he met his wife and they opened a fruit stand in La Mesa. Over the years, they successfully started and sold many retail businesses. Henry's three sons started the second generation of Boney stores in 1969, and the tradition carried on for several decades.

The name changed to Henry's Marketplace in 1997, and Wild Oats bought the chain in 1999. The Boney sons moved to Chandler, Arizona and founded Sprouts in 2002. A series of transactions soon followed. In 2007, Whole Foods purchased Wild Oats and sold the Henry's Stores to Smart and Final. A large private equity firm called Apollo Management proceeded to buy Smart and Final. Then, in 2011 Apollo bought a controlling interest in Sprouts in 2011 (then comprised of 63 stores), and Smart and Final sold Henry's to Sprouts (Henry's had 34 stores in California and 9 in Texas). This combined the Boney family's stores into one company and initiated a significant growth period for Sprouts Farmers Market.

Sprouts purchased Sunflower Farmers Market in 2012, and this addition of 35 stores expanded the company's reach to cover Nevada, Utah, New Mexico and Oklahoma, and extended its presence in California, Arizona, Colorado and Texas. Sprouts grew to about 150 stores by the end of 2012 and had 11,000 employees in 8 states. The company's IPO occurred on August 1st of this past year, selling 18.5 million shares at $18 per share for a total of $333 million. By the end of the day, shares had leapt to $40.11, representing an astonishing 123% increase fueled largely by the promise of significant future growth. Since then, the share price has fluctuated and now trades at around $34. Thus far, most of Sprouts' history centers around mergers and acquisitions, but the near future will be defined by location expansion.

Financial Analysis

Profitability & Shareholder Returns

Sprouts has achieved considerable growth in sales and profitability largely as a result of its recent expansion. Net sales increased 35.8% from $1.79 billion in 2012 to $2.44 billion in 2013.[1] Over the same period, net income increased 163.2% from $19.5 million to $51.3 million as the company's net margin improved. In 2013, Sprouts opened 19 new stores to build its store base to 167, and the company looks to continue expansion with 22 to 24 more planned openings in 2014.

	Sprouts	**Whole Foods**	**Natural Grocers**
Sales Growth	35.83%	10.41%	28.02%
Net Income Growth	163.21%	18.24%	41.13%
Gross Margin Ratio	29.75%	35.84%	29.20%
Inventory Turnover	15.81	21.04	7.35
Total Asset Turnover	2.14	2.38	1.85
Return on Assets	4.51%	10.17%	4.54%
Return on Equity	11.40%	14.35%	8.23%

Compared with industry competitors Whole Foods and Natural Grocers by Vitamin Cottage, Sprouts has exceptional sales growth and net income growth, but only modest to sub-par return on assets and return on equity (4.51% and 11.40%, respectively). This low return on assets reflects the company's commitment to providing healthy grocery options to customers at low costs, which results in relatively low gross margin ratio of 29.8%.[2] Thus, in order to make profitability gains the company will have to focus on increasing its activity, either by attracting

1 Sprouts 10-k 2013
2 Yahoo Finance: Sprouts Farmers Market

more customers or increasing the average customer purchases made at the store. The company's ROE is much more attractive at 11.40%, but comes with the risk involved with highly leveraged companies.

Sprouts has a healthy inventory turnover of 15.81, although this still falls short of Whole Foods. Sprouts could potentially increase its turnover through more efficient inventory practices or data mining that would allow the company to better predict what inventories to stock on-hand.

Since Sprouts only recently IPO'd, it has yet to pay dividends to its shareholders. Its revenues per share is only $17.44, which is significantly lower than Kroger's $189.18 and Whole Foods' $35.48. Sprouts' stock price reflects the promise of future growth, rather than immediate dividend payouts. Thus, it is doubtful that shareholders will see an immediate return on their purchase and Sprouts' stock should be treated as a long-term investment.

Liquidity & Solvency

Sprouts does not appear to have problems with liquidity, as the company has a current ratio of 1.32 and a quick ratio of 0.50. A current ratio greater than one indicates that the company's current assets exceed its current liabilities. A quick ratio of 0.50 might appear a little low, but can be explained by the company's recent expansions. Because the company is growing, Sprouts has converted many liquid assets into long-term assets in the form of stores. Both the company's current ratio and quick ratio indicate that company can continue to operate healthily and meet its short-term debt obligations.

	Sprouts	Whole Foods	Natural Grocers
Current Ratio	1.32	1.82	1.56
Quick Ratio	0.50	1.22	0.32
Financial Leverage	2.53	1.41	1.81
Interest Coverage Ratio	3.26	n/a	8.82

Sprouts has a high leverage ratio of 2.53, meaning that the company finances a majority of its activities with debt. It does not appear that the company will have trouble meeting its debt obligations, however, as the company's interest coverage ratio equals 3.26. Even though the company is not at risk of insolvency, such a high leverage ratio poses a significant risk to shareholders. If the company cannot generate sufficient return on assets to exceed the cost of debt, then return on equity ends up diluted. However, greater leverage can also generate greater returns to shareholders when the company is profitable.

DuPont Analysis

As mentioned above, Sprouts has a below average ROA of 4.51% when compared to Whole Foods and Natural Grocers.

	Sprouts	Whole Foods	Natural Grocers
Tax Burden	61.05%	61.63%	62.32%
Interest Burden	69.32%	100.00%	88.66%
EBIT Margin	4.97%	6.92%	4.43%
Net Profit Margin	**2.11%**	**4.27%**	**2.45%**
Total Asset Turnover	2.14	2.38	1.85
Return on Assets	**4.51%**	**10.17%**	**4.54%**
Financial Leverage	2.53	1.41	1.81
Return on Equity	**11.40%**	**14.35%**	**8.23%**

ROE = Profit Margin * Total Asset Turnover * Equity Multiplier

Both net profit margin and total asset turnover drive ROE, and typically for retailers there is a tradeoff between the two. A retail grocer like Sprouts can decrease its prices and gross margins in order to spur asset turnover, or it can increase its margins and risk decreasing asset turnover. Depending on the elasticity between prices and asset turnover, there exists some optimal price level where ROE is maximized.

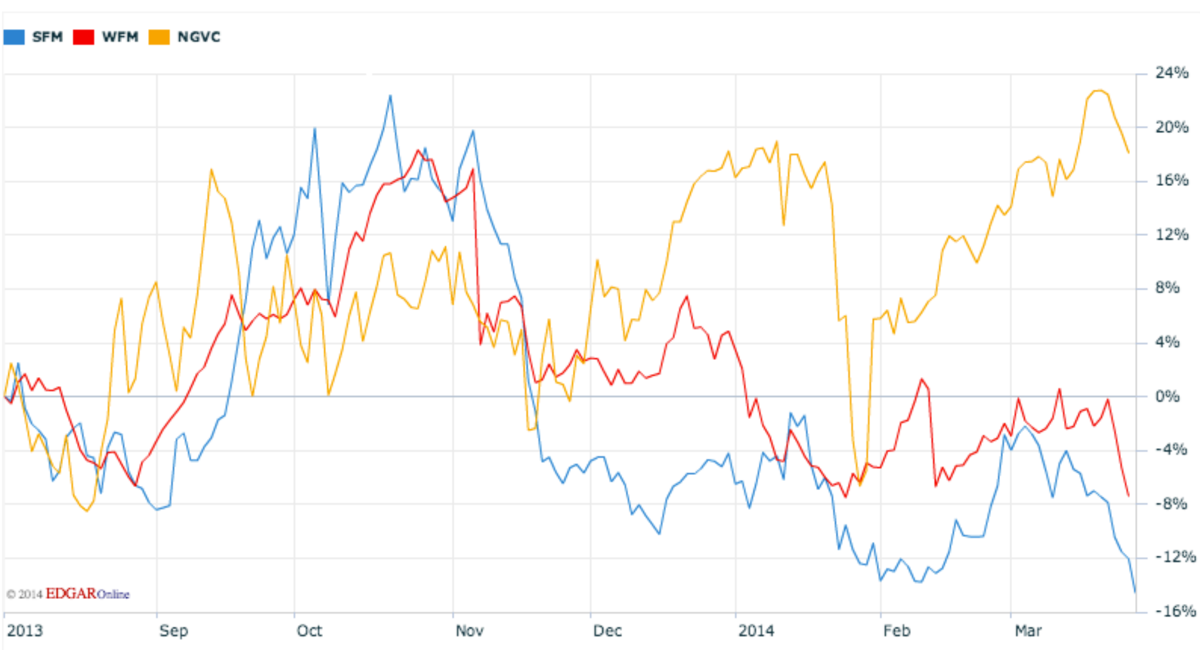
Of the three companies mentioned above, in 2013 Sprouts has the lowest net profit margin at 2.11%, which falls in line with the company's mission of "Healthy Living for Less." However, Sprouts also has a modest asset turnover of just 2.14. Whole Foods has higher net margins and higher turnover. While Sprouts may want to keep its margins where they are, in order to increase profitability the company must find a way to boost its asset turnover. Improved brand awareness would help, or the company might look into developing a customer loyalty rewards program to encourage customers to shop at Sprouts. Because the company is committed to keeping its prices and margins low, the only way to improve profitability is to increase activity and asset turnover.

In any case, Sprouts exhibited a solid ROE of 11.40% in 2013, which largely resulted from the company's high leverage ratio of 2.53. This level of debt financing benefits shareholders when the company is profitable, but also poses a significant amount of risk if the company cannot generate ROA in excess of its cost of debt. Sprouts is not at immediate risk of insolvency, but shareholders should invest cautiously with such a high leverage ratio, especially if the company fails to increase its turnover.

Stock Performance

Sprouts (NASDAQ: SFM) held its IPO on August 1st, 2013 at a stock price of $18, which skyrocketed to close at over $40 that first day. Although SFM had one of the most successful IPOs of the decade and peaked at nearly $50, the stock now trades at $36.47 (as of March 30, 2014). The company has a market capitalization of $5.39 billion.

Sprouts trades at a P/E ratio of 98.57, which is significantly higher than Whole Foods multiple of 34.10, which indicates that the market believes that Sprouts still has significant opportunities for growth and expansion within the health food industry.



Five Forces Analysis

Introduction

Sprouts Farmers Market is the second largest natural organic food retailer in the United States.[3] Competition in the food retail business is fierce, and buyer switching cost is very low. As such, the industry has been demarcated into a few companies with great control over their niches which generally span the country. Sprouts is looking to carve itself out a niche in low cost organic foods, and is relying on low switching cost for consumers to break into those markets.

Threat of new Entrants

- Barriers to entry are high
- Government policy has the potential to affect Sprouts through legislation related to production and sale of organic foods.
- Food production is one of the major economies of scale.
- Brand is extremely important in the food retail industry
- Food retail, right now, has very small switching costs
- Overall industry profitability is high
- Evolution of industry creating new threats

Overall threat of new entrants into the grocery industry is low, as barriers to entry and growth are so high. Fixed cost entry barriers are high as traditional entry into this business requires the purchase of stores, which Sprouts aggressively pursues. Sprouts has already entered the market, and while it must pay money for more stores to expand, it is already experiencing some of the returns to scale, and is finding it much easier to grow.

The government sets standards for food retail that requires grocers indirectly to have a large amount of fixed capital. For example, the USDA National Organic Standards Board sets standards for organic producers to meet. This requires other grocers to have the capital to both purchase foods that meet those standards and ensure that they can continue to meet those

[3] Hoovers

standards. Sprouts has firmly established connections with large organic growers, and represents a significant part of the industry. Therefore, it can both create its own secondary certification program to help its growers meet NOSB standards and influence government policy.

Grocery vending and food production are both industries with notable economies of scale. We believe Sprouts is still experiencing positive returns to scale, which we identify through its recent acquisition of Sun Foods, Inc. and its 40 stores. Sprouts has excellent relationships with growers and sellers, making it able to compete with Whole Foods and Trader Joe's thus far. Sprouts is currently in nine states, where it is able to compete with Whole Foods and Trader Joe's on quality, with lower prices close to Safeway's. If its major competitors are Trader Joe's, Whole Foods, and Safeway, it still has a lot of room for expansion. Continuing this growth will allow Sprouts to take further advantage of economies of scale to drive prices even lower.

Sprouts was recently rated 5th best supermarket in the United States by consumer reports, but next to giants like Whole Foods and Trader Joe's, it remains largely unknown. Sprouts' tagline is: "Healthy Living for Less," and while it has been warmly received where it has expanded, as a representative of "healthy living," it has great potential for brand expansion. Its competitors, especially Trader Joe's, are known for their quality house-brand food products, which Sprouts is lacking. Consumer reports note that house-brand products were a primary method for cutting consumers' costs.

Switching costs in the supermarket industry are essentially measured in drive times, which means that customer loyalty is hard to build and even harder to maintain. Furthermore, consumer benefits programs in the industry traditionally have low returns for customers. Sprouts can introduce some sort of customer benefits, or raise these benefits, to raise switching costs for its customers. This is a double-edged sword however, as this means that Sprouts will have to invest in the infrastructure to make something like this seem worthwhile to the consumer.

Overall industry profitability is high, but margins are very slim. The profitability would create lots of competitors but fixed costs are huge. That said, Sprouts does compete with all Mom and Pop food retailers. Sprouts' image as a "farmer's market," could allow them to influence struggling food retailers' sell-out decisions. Sprouts should put effort into preventing these Mom and Pop retailers from selling their stores to competitors.

Though the barriers to entry to wholly new players are small, the industry is changing. Wal-Mart and Target's entries into the market have been significantly disruptive as their tremendous purchasing power allows them to increase competition for sellers. Because the margins in the industry are so low, the industry is quite vulnerable to revolutionary changes. For instance, online grocery vending, such as AmazonFresh, could grow to be a dangerous threat. To account for this, Sprouts needs to pursue innovative strategies to stay competitive in the future.

Threat of Substitutes

- Buyer propensity to substitute can be large
- Price performance of substitutes
- Buyer switching costs are low
- As switching costs are so low, product differentiation is important.

Buyer propensity to substitute in this industry is high and largely based on location and price. Location is the most important determinant of buyer propensity to substitute for Sprouts, as Sprouts already does well competing on price. Sprouts is in the business of competing on location with other food retailers. Their recent merger with Sunflower Foods has given them a lot more access to buyers, with 37 new stores, and they are continuing to expand aggressively.

Price performance of substitutes is where Sprouts has strength. While Trader Joe's and Whole Foods are bigger chains, have extremely high profit margins, and get massive returns to scale, Sprouts does sell cheaper, better quality perishables, which have been rated number one by consumer reports. Sprouts has committed itself to offering lower prices for organic food, and with returns to scale we will see better price performance from Sprouts. It seems unlikely that they will pursue a strategy of competing with very low cost grocers like Safeway, as that would be detrimental to their brand image.

Consumer switching costs in grocery vending are nearly zero. There is little Sprouts can do to raise buyer switching costs, other than offering a rewards program, or somehow capturing enough of the market that competitors no longer offer low-price organic food. If they are able to do this, Sprouts can force consumers to have to choose between organic and non-organic foods. A more viable strategy, however, is to create a customer loyalty program that locks in members in some way.

With low switching costs, market differentiation is a key method to draw customers from different market segments. Sprouts does, in fact, offer a significantly differentiated product from its competitors with its commitment to offering organic foods, and its strategy of delivering those foods seasonally. We believe Sprouts needs to put more effort into improving consumer recognition of differentiation, as the difference between Sprouts and its competitors is significant upon close research. Sprouts has not yet reached enough returns to scale to have the low point on the price/quality curve that it seeks to reach. This is causing it to compete with Trader Joe's, where customers are having trouble comparing price and quality for the two companies.

Bargaining Power of Customers

- Buyer concentration to firm concentration ratio is high
- Bargaining leverage is high for customers already in store
- Buyer information at any point in time about different retailers' prices for specific foods is low without expending a lot of effort.
- High availability of substitute products

Despite Sprouts' many competitors, everybody is a potential customer. Clearly the idea of Sprouts is powerful, as its profits, expansion, and reviews have indicated. Once consumers are in the store, Sprouts can show consumers how well they compete on price and freshness of produce. This is where the idea of Sprouts as the organic food retailer works best, as consumers can see the fresh organic produce and have access to the signals Sprouts works hard to send its customers inside the stores.

Buyer information comparing stores' prices is low, but consumers do know that they can get substitutes for nearly everything. Quality delivery of some sort is therefore very important so that consumers believe they always get the best deal. Sprouts seems to be having trouble sending buyers signals about the deals that they get in the store, as thoughts about Sprouts' prices vary. Sprouts offers low prices, but people cannot always accurately compare these prices to the prices of competitors.

Sprouts benefits from being the organic producer, which certainly lowers buyers' price sensitivities. Safeway is below Sprouts on the price/quality curve and offers some substitutes, but their quality is significantly lower. It may not be a good idea to position itself directly between those Safeway and Whole Foods where it will face pressure from both sides. Sprouts' brand gets damaged both ways. It's branded as a high cost store in consumers' minds when it competes with Whole Foods, but low quality when it competes with Safeway.

Bargaining Power of Suppliers

- Supplier switching costs are medium
- Supplier concentration/firm concentration
- Impact of inputs on costs and input differentiation

Grower switching costs for Sprouts are made comparatively higher by Sprouts' focus on the organic produce market. Sprouts cannot wield as much influence in the whole grocery market as Safeway or Whole Foods, but by focusing on the organic produce market they can become a crucial bulk buyer for growers. The importance of these relationships reduces supplier bargaining power. Given that Sprouts has been commended for investing in creating long-term relationships with growers, we can infer that there are switching costs for buyers and that Sprouts is good at reducing risk for growers. Switching costs for growers are medium however, because there is almost always a market for food, even if they have to sell at a reduced price, so growers can usually find an alternative even if it hurts.

Supplier concentration to firm concentration ratio is high, but falling. According to Hoover's, "while large companies buy directly from manufacturers, small chains and independent retailers rely on wholesalers." Because Sprouts is comparatively small and produces organic foods, it almost certainly has to go through wholesalers.

Minimizing the impact of inputs on costs and differentiation is crucial to Sprouts. Any jump in food prices is likely to affect Sprouts. Not only that, but because it sells organic foods, its sellers might be more affected by changing conditions than other sellers. Sprouts does well diversifying, and has an advantage by selling foods only in season. Other firms will be impacted similarly by price shocks, so it seems unlikely one firm will gain a huge advantage over another from something like this.

Intensity of Competitive Rivalry

- Sustainable competitive advantage through innovation is difficult
- Advertising expense is considerable
- Degree of transparency is low, but improving
- Firm concentration ratio is high but falling.

Innovation in grocery vending is difficult, mostly because the traditional business model is so entrenched that finding consumers to adopt any innovation is challenging. Sprouts' focus on cheap organic produce is an innovative and very successful business model. Whether this is a sustainable model is not certain, as there is question about whether organic foods are a fad. However, organic food sales have grown by over 5% per year every year since 2009 and the industry shows no signs of slowing.

Sprouts spends around $37 million on advertising and selling expenditures, which amount to about 3% of sales. Given that Sprouts is rapidly expanding, this seems inconsistent. In order to improve efficiency of turnover, Sprouts should be increasing advertising expenditures. Sprouts does have a minimal online presence compared with its competitors, which is an area they could dominate.

Another area of market interest that Sprouts could potentially lead should it invest resources is in supply chain transparency. In the overall food retail market, consumer interest is high for food safety reasons and to produce trust in the consumer. Given Sprouts' excellent connections with its growers, and the need for it to monitor seasonal food production, it should have an advantage in producing transparency. Additionally, it is questionable whether the organic food market is currently as transparent as the rest of the food market. Sprouts could derive a significant competitive advantage from improving this transparency

While the overview is positive for Sprouts, assuming market dominance will be a long and hard road for Sprouts as according to Hoover's, "The US industry is concentrated: the 50 largest companies generate about 70 percent of revenue." Still, according to the USDA ERS, the market share of the top four competitors in the industry is falling. Traditional grocery outlets are facing competition from supercenters and other atypical sellers that are moving to secure niche markets.

Conclusion

Although competition in the industry is tough, Sprouts stands a good chance of being able to carve itself out a competitive space. Sprouts should continue to solidify its relationships with growers to help maintain a stable supply chain, which will ease their ability to expand. Through this expansion, they will be able to lower costs for consumers and reduce competition from above, which is its current weakness.

SWOT Analysis

Strengths	Weaknesses
• High-quality products • Supplier relationships resulting in low prices • Differentiated product • Ownership with substantial cash • Loyal customer base	• Unable to offer certain products year-round • Small market share • Employee relations issues
Opportunities	**Threats**
• Cash infusion from IPO allows for location expansion • Create a customer loyalty program • Increasing market share of healthy, natural grocers	• Expansion of Trader Joe's • Safeway and other large grocery chains beginning to offer fresh, organic options • Slow growth of grocery store market

Strengths

Sprouts offers fresh, natural and organic foods that are widely regarded as high-quality. In particular, produce is purchased from local growers near each location, resulting in a fresh product. The freshness of the food and ingredients contributes to improved taste and customer satisfaction; online reviews suggest that customers are pleased by the quality of the products they purchase at Sprouts.

Relationships with growers and suppliers of other products are carefully cultivated and managed over time to allow Sprouts to stock its inventory at a lower cost, and the savings are passed on to customers. In all of its areas of operations, Sprouts ensures that it has growers in close proximity to keep quality high and costs low. No natural grocer can match the prices Sprouts offers.

Although Sprouts has a few close competitors, it offers a differentiated product. It can be seen as the only low-cost, high-quality natural grocery store in the market, as it is less expensive than stores like Whole Foods and Trader Joe's and more health-oriented than Safeway and Kroger's. Furthermore, its offerings of bulk foods, dietary supplements and smaller stores with an open floor plan further distinguish the chain.

Apollo Global Management, which owns Sprouts, is a huge firm that is flush with cash; in 2013, the company held $1.08 billion in cash and short-term investments. Raising funds for operations or expansion will not likely be an issue Sprouts will have to face, and this ownership provides financial stability not shared by all of the competitors in the natural grocery market.

In the locations Sprouts is established, it boasts a loyal customer base. Customers enjoy the low prices, high quality and unique shopping experience Sprouts provides, leading to the conversion of many "trial" customers into what the company labels "lifestyle" customers.[4] These customers are vital to the company's future, as they shop at Sprouts more often and purchase a wider range of products upon each visit.

Weaknesses

The nature of the products Sprouts offers makes the company subject to seasonality. Some of the produce sold can only be obtained at a low price during certain times of the year, depending on the growing seasons. Customers used to shopping at supermarkets, which offer most varieties of produce year-round, may find this to be a reason not to shop at Sprouts. We do not advocate that Sprouts stocks all produce year-round, however, as this would clash with the company's basic foundation as a "farmers market" offering fresh, natural produce.

Although Sprouts enjoys a large share of the natural grocery market, it captures a small share of the total grocery store market. Companies like Kroger's ($98.4 billion in sales in 2013) and Safeway ($36.1 billion) dwarf Sprouts ($2.44 billion). Small market shares are associated with low bargaining power and smaller economies of scale.

[4] http://investors.sprouts.com/secfiling.cfm?filingid=1193125-14-73116&cik=

Reports of employee relations issues have arisen recently. Employees complain about disorganized management of individual stores, insufficient training and measly annual raises.[5] Furthermore, some employees have suggested that the difficulty of getting promotions leads to unmotivated workers. Sprouts operates on small margins, so employee inefficiency poses a serious issue.

Opportunities

Sprouts' IPO this past August made $333 million dollars available for expansionary purposes. As Sprouts looks to grow its brand, moving into new locations will be key. It has targeted the US Southeast as its newest area for expansion[6], and it plans on opening 20 stores in 2014.[7] With a high initial cost of building new locations, this IPO will prove vital for future growth.

Customer loyalty is vital in the grocery industry, and Sprouts has the opportunity to increase this through a loyalty program that could potentially include awarding points for purchases and referrals of friends. Creating an app that includes membership information, coupons and shopping lists could further increase loyalty and attract new customers. Loyalty programs have been shown to increase the number of visits per customer and the amount each customer spends per visit.

Healthy, natural grocers have been capturing some of the grocery market share from larger, supermarket-type stores like Safeway.[8] From 2005-2009, the sales of natural and organic food grew 85%, compared to a 2-3% annual growth rate of total groceries.[9] Increased health-consciousness among consumers might allow this market share to increase further.

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5 http://www.glassdoor.com/Reviews/Sprouts-Farmers-Market-Reviews-E134467.htm

6 http://www.bizjournals.com/atlanta/print-edition/2013/08/16/sprouts-sees-metro-atlanta-as-growth-hub.html?page=all

7 http://www.bloomberg.com/news/2013-08-01/sprouts-skyrockets-after-pricing-organic-grocery-ipo-above-range.html

8 http://subscriber.hoovers.com/H/industry360/overview.html?industryId=1535

9 http://www.pcg-advisors.com/marketstatistics

Threats

Although Trader Joe's is a private company and thus does not have readily available financial information, it is becoming further established in the market as a desirable place to shop. A recent survey of 6,600 consumers scored Trader Joe's as the company with the highest customer satisfaction[10], and it is not even close. The high level of competition from Trader Joe's is a significant threat to Sprouts.

Large grocery stores like Safeway have taken notice of the trend of increased health awareness and have begun to offer more organic, fresh and all-natural products. As of 2011, the three largest organic grocery retailers in North America were Walmart, Costco and Kroger's. While the quality and nutrition of the products offered by these companies may fall short of what Sprouts sells, this makes these types of stores more of a direct threat to natural grocers.

The total grocery store market is growing at a slow or negative pace, with an average reported annual growth of -0.4% from 2009-2014. While natural grocers are expanding to take up more of the market share, the total market limits the potential expansions of companies like Sprouts.

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[10] http://www.marketforce.com/press-releases/item/trader-Joe's-is-consumers-favorite-grocery-chain-according-to-market-force-study-/

Strategic Recommendations

Sprouts Farmers Market's current strategy is to operate as a "high-growth, differentiated, specialty retailer of natural and organic food focusing on health and wellness at great value"[11]. This is not just rhetoric; examining the business reveals all of the mentioned strategies. DangerZone is confident that the market for healthy, natural foods promises significant growth, and Sprouts should work to capture this growth by differentiating itself from its competitors by offering low prices and a unique shopping experience. DangerZone believes that these strategies are likely to lead to future growth and offers a few suggestions to improve the focus of the goals.

Keep Customer Loyalty High

Sprouts currently enjoys a high level of customer loyalty, and maintaining this through the company's expansion will be key. Converting "trial" customers into "transition" customers through the advertisement of fresh produce is effective, and some transition customers develop into "lifestyle" customers, or frequent customers that shop in a wide range of departments. Targeted advertising and word-of-mouth must continue to initially draw customers, but we believe that the company needs to focus on cultivating lifestyle customers in the areas to which Sprouts is expanding.

Create a customer loyalty program

Customer loyalty programs are common ways grocery store chains persuade customers to return frequently and buy more products. For example, Safeway offers a "Safeway Club Card" that gives members discounts on purchases and offers programs that can allow customers to generate donations to local schools.[12] Programs are often free of cost and can boost sales if implemented correctly.

[11] http://investors.sprouts.com/secfiling.cfm?filingid=1193125-14-73116&cik=
[12] www.safeway.com/ShopStores/Card-Programs.page

We recommend that the first step in Sprouts' loyalty program is the creation of a membership card with free sign-up for all customers. Modeling the design after successful implementations in other stores, we believe that the membership card should be required to receive the discounts posted around the store. This will give customers clear incentives to sign up, and these new memberships will help Sprouts better keep track of the shopping habits of its customers. This information is vital in the grocery store industry, as it enables companies to increase efficiency in the form of faster inventory turnover.

Along with in-store discounts, we envision Sprouts' new members to have the option of receiving exclusive coupons that can increase in-store savings. We will touch on this, as well as other aspects of membership, below.

Develop a mobile app

While we encourage the option of a physical, credit card-style membership card, we find a lot of potential benefits in developing a mobile app containing membership information that can be downloaded to customers' smartphones. The app we envision will allow customers to sign up for Sprouts membership on a mobile device, making the process more convenient for them and keeping in-store lines from getting backed up by people filling out personal information at registers. The data will also be easier to collect by Sprouts in a central database. Upon checkout, members can pull up a barcode on the app that scans their membership information, or they can provide the cashier with the telephone number associated with the account.

Including other features on the Sprouts app can lead to huge benefits with low cost. The first feature is a section that features coupons sent to the individual based on observed shopping habits. For example, if a customer is only purchasing coffee at Sprouts, he or she could be sent coupons on reduced cost produce in an attempt to increase the number of sections of Sprouts at which this person shops. Coupons for high-quality products can also increase overall customer satisfaction, leading to more brand loyalty.

Providing the option for current members to refer friends through the app is a simple way to incentivize word-of-mouth, which Sprouts depends on heavily to advertise and establish its brand. When the app is downloaded, one of the questions the new member is asked to answer will be the name of the friend who told the person about the app, if applicable. For each time someone puts down a member's name, this referrer could be sent a gift card or extra coupons, encouraging people to tell their friends about Sprouts and the company's mobile app. Our final suggestion for the app is to create a shopping list feature, where members can write down the groceries they need for the week. This function can also target increased efficiency.

Increase Efficiency Across All Stores

Sprouts' focus on offering high-quality products at low prices results in small margins at the point of sale. While this business model has been successful thus far, it makes efficiency extremely important, as profits can disappear quickly if operations do not go as planned. DangerZone believes that Sprouts' future growth relies on maintaining and increasing efficiency across all business operations.

In the grocery industry, efficient operations revolve around inventory turnover. Since much of the inventory of Sprouts is perishable, it is vital for the company to sell items as quickly as possible once deliveries are received and stocked. Currently, Sprouts has an inventory turnover of 15.81, which means the average piece of inventory remains in-store for about 23 days before it gets sold. Turnover varies on the nature of the product (i.e. produce turns over faster than frozen foods), but aggregating the turnover rates provides useful information. Sprouts' turnover is fast enough to result in healthy profit, but when comparing this to Whole Foods' turnover rate of 21.04 (about 17 days in-store, on average), it is clear that room for improvement exists. Sprouts' recent partnership with the supply chain analytics firm Living Naturally8 can help them streamline inventory supply with the goal of increasing turnover. The company clearly recognizes the need to increase efficiency, and our proposed mobile app offers a lot of potential in this area.

Including a grocery list function on the app would allow members to type in what they need to buy during their next visit to Sprouts. To increase ease-of-use, the app could suggest what item a member is typing before the word is finished, with priority going to previously purchased items. To clarify, if a user types "b-a-n", the app could suggest "bananas", and if this is what the user wants, the rest of the word would not have to be typed. This function offers a convenient way for customers to keep a shopping list on hand at all times, and the benefits to Sprouts could be even greater. When app users type in the foods they plan to buy, this information is collected and can be used to know how much of each item will be needed in inventory. As the number of app users rises, Sprouts will have information about what the customers of each store plan on buying, and they can build up their inventory accordingly. Inventory turnover will increase as management will know which items to keep a lot of on hand and which items will be less popular sellers in that time period. All of this relies on a large user base and continued use of the shopping list function, but we believe that the future of the grocery industry is moving towards this.

Areas of Expansion

Expansion of Sprouts is currently in an aggressive phase, with the company planning on opening over 20 new stores in 2014. Increased sales revenue has led the company to believe that the Sprouts brand is strong enough to support a broader store base, and we at DangerZone agree that carefully planned expansion could lead to a stronger company. However, this expansion must be carefully planned, as overexpansion is always a serious risk.

Sprouts has targeted the Southeast United States as the next area to build new stores, with its newest locations set to open in Atlanta later this year. We have identified the Pacific Northwest as another area of potential expansion, as a significant market for healthy, organic foods exists in Washington and Oregon. Furthermore, Sprouts is becoming well-established in California, so this growth would not represent a big geographic leap. Since Sprouts' low prices come from good relationships with suppliers, any expansion must keep this in mind and allow these relationships to develop before stores are opened. We believe that the Northwest would be a good location to do so because of the abundance of smaller growers in the region. Partnership opportunities may be more prevalent in the Northwest than the Southeast, so we recommend that Sprouts research the two areas closely and compare supply chain viabilities before pursuing further expansion.

Further Establish Brand

While Sprouts has a loyal customer base, its name is still not as widely known as some of its competitors (Trader Joe's, Whole Foods). Establishing the Sprouts brand will be vital for the company's future. One suggestion to help do this could be to increase transparency of where Sprouts gets its supplies. An example of this is displaying the location where each type of produce was picked on the signs by the fruits and vegetables. The Sprouts brand would be further differentiated in the minds of consumers, and they might pass this along to people they know.

Another way to spread the name of Sprouts is through a heightened social media presence. Currently, Sprouts is using Facebook regularly and boasts over 250,000 "likes", but it is not taking full advantage of its Twitter and Instagram accounts (less than 10,000 followers on each site). By posting pictures and descriptions of the healthy, natural products the company offers, Sprouts could attract a wider customer base and persuade current customers to try new products. We recommend the hiring of a full-time social media coordinator.

Concluding Remarks

Overall, DangerZone believes in Sprouts' business model and feels optimistic about the future health of the company. The recommendations we detailed do not work towards changing the foundation of the company, and we warn against anything that would do so, such as overly aggressive expansion or fundamental changes to the quality or price offered by Sprouts. Sprouts enjoys a competitive advantage with its relationships with suppliers that lead to high quality products at low costs, and the company should continue to utilize this while simultaneously fixing its weaknesses and setting itself up for future profitability.