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Sprouts Farmers Market, Inc.
Form 10-Q
November 01, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2018

Commission File Number: 001-36029

Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

Delaware 32-0331600
(State or other jurisdiction of (I.R.S. Employer

incorporation or organization) Identification No.)

5455 East High Street, Suite 111

Phoenix, Arizona 85054

(Address of principal executive offices and zip code)

(480) 814-8016

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company,” and “emerging growth company” in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of October 29, 2018, the registrant had 127,603,836 shares of common stock, \$0.001 par value per share, outstanding.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2018

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Forward-Looking Statements

This Quarterly Report on Form 10-Q contains “forward-looking statements” that involve substantial risks and uncertainties. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (referred to as the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (referred to as the “Exchange Act”), including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, and plans and objectives of management. In some cases, you can identify forward-looking statements by terms such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “might,” “plan,” “project,” “will,” “would,” “should,” “could,” “can,” “predict,” “potential,” “objective,” or the negative of these terms, and similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievement to be materially different from those expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors” included in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, and our other filings with the Securities and Exchange Commission. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

As used in this Quarterly Report on Form 10-Q, unless the context otherwise requires, references to the “Company,” “Sprouts,” “Sprouts Farmers Market,” “we,” “us” and “our” refer to Sprouts Farmers Market, Inc. and, where appropriate, its subsidiaries.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	September 30, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 17,175	\$ 19,479
Accounts receivable, net	34,631	25,893
Inventories	253,045	229,542
Prepaid expenses and other current assets	37,523	24,593
Total current assets	342,374	299,507
Property and equipment, net of accumulated depreciation	773,348	713,031
Intangible assets, net of accumulated amortization	195,154	196,205
Goodwill	368,078	368,078
Other assets	16,010	4,782
Total assets	\$ 1,694,964	\$ 1,581,603
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	\$ 245,928	\$ 244,853
Accrued salaries and benefits	43,433	45,623
Current portion of capital and financing lease obligations	7,398	9,238
Total current liabilities	296,759	299,714
Long-term capital and financing lease obligations	120,670	125,489
Long-term debt	435,000	348,000
Other long-term liabilities	144,401	130,640
Deferred income tax liability	56,839	27,066
Total liabilities	1,053,669	930,909
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Undesignated preferred stock; \$0.001 par value; 10,000,000		
shares authorized, no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 200,000,000 shares authorized,	127	132
127,603,836 shares issued and outstanding, September 30, 2018;		

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132,823,981 shares issued and outstanding, December 31, 2017		
Additional paid-in capital	653,509	620,788
Accumulated other comprehensive income (loss)	4,567	(784)
(Accumulated deficit) retained earnings	(16,908)	30,558
Total stockholders' equity	641,295	650,694
Total liabilities and stockholders' equity	\$1,694,964	\$1,581,603

The accompanying notes are an integral part of these consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	September 30,	October 1,	September 30,	October 1,
	2018	2017	2018	2017
Net sales	\$1,329,109	\$1,206,059	\$3,937,998	\$3,520,679
Cost of sales, buying and occupancy	946,734	859,650	2,788,159	2,494,998
Gross profit	382,375	346,409	1,149,839	1,025,681
Direct store expenses	281,365	250,191	816,933	715,336
Selling, general and administrative expenses	43,944	39,955	128,828	110,312
Store pre-opening costs	3,819	2,456	9,414	10,055
Store closure and other costs	461	803	497	992
Income from operations	52,786	53,004	194,167	188,986
Interest expense	(7,419)	(5,609)	(20,028)	(15,447)
Other income	—	162	325	388
Income before income taxes	45,367	47,557	174,464	173,927
Income tax provision	(7,867)	(16,071)	(28,631)	(55,186)
Net income	\$37,500	\$31,486	\$145,833	\$118,741
Net income per share:				
Basic	\$0.30	\$0.23	\$1.13	\$0.87
Diluted	\$0.29	\$0.23	\$1.12	\$0.86
Weighted average shares outstanding:				
Basic	126,855	134,320	129,572	136,063
Diluted	127,627	136,770	130,537	138,860

The accompanying notes are an integral part of these consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(UNAUDITED)

(IN THOUSANDS)

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	September 30,	October 1,	September 30,	October 1,
	2018	2017	2018	2017
Net income	\$37,500	\$31,486	\$145,833	\$118,741
Other comprehensive income, net of tax				
Unrealized gain on cash flow hedging				
activities, net of income tax of \$299, \$0,				
\$1,851 and \$0	865	—	5,351	—
Total other comprehensive income	\$865	\$—	\$5,351	\$—
Comprehensive income	\$38,365	\$31,486	\$151,184	\$118,741

The accompanying notes are an integral part of these consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

				(Accumulated deficit)	Accumulated Other	Total
	Common	Paid In	Retained	Comprehensive	Stockholders'	
	Shares	Stock	Capital	Earnings	Income (Loss)	Equity
Balances at January 1, 2017	140,002,242	\$ 140	\$ 597,269	\$ 75,500	\$ —	\$ 672,909
Net income	—	—	—	158,440	—	158,440
Other comprehensive income						
(loss)	—	—	—	—	(784)	(784)
Issuance of shares under stock						
plans	2,144,669	2	9,298	—	—	9,300
Repurchase and retirement of						
common stock	(9,696,819)	(10)	—	(203,382)	—	(203,392)
Equity-based compensation	—	—	14,221	—	—	14,221
Balances at December 31,						
2017	132,450,092	\$ 132	\$ 620,788	\$ 30,558	\$ (784)	\$ 650,694
Net income	—	—	—	145,833	—	145,833
Other comprehensive income						
(loss)	—	—	—	—	5,351	5,351
Issuance of shares under stock						
plans	3,170,818	3	21,048	—	—	21,051
Repurchase and retirement of						
common stock	(8,411,575)	(8)	—	(193,299)	—	(193,307)
Equity-based compensation	—	—	11,673	—	—	11,673
Balances at September 30, 2018	127,209,335	\$ 127	\$ 653,509	\$ (16,908)	\$ 4,567	641,295

The accompanying notes are an integral part of these consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(IN THOUSANDS)

	Thirty-nine Weeks Ended September 30,	
	2018	October 1, 2017
Cash flows from operating activities		
Net income	\$ 145,833	\$ 118,741
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	81,959	70,875
Accretion of asset retirement obligation and closed store reserve	219	168
Amortization of financing fees and debt issuance costs	658	347
Loss on disposal of property and equipment	404	820
Equity-based compensation	11,673	10,325
Deferred income taxes	29,773	23,245
Changes in operating assets and liabilities:		
Accounts receivable	(10,299)	1,660
Inventories	(23,503)	(17,752)
Prepaid expenses and other current assets	(13,758)	(3,734)
Other assets	(3,945)	(702)
Accounts payable and other accrued liabilities	3,240	35,957
Accrued salaries and benefits	(2,130)	8,360
Other long-term liabilities	15,342	10,659
Cash flows from operating activities	235,466	258,969
Cash flows from investing activities		
Purchases of property and equipment	(148,433)	(158,459)
Proceeds from sale of property and equipment	1	30
Cash flows used in investing activities	(148,432)	(158,429)
Cash flows from financing activities		
Proceeds from revolving credit facilities	180,000	134,000
Payments on revolving credit facilities	(93,000)	(40,000)
Payments on capital and financing lease obligations	(3,349)	(3,053)
Payments of deferred financing costs	(2,131)	-
Cash from landlords related to capital and financing lease obligations	2,113	300
Repurchase of common stock	(193,307)	(192,000)
Proceeds from exercise of stock options	21,051	6,640
Other	(59)	—
Cash flows used in financing activities	(88,682)	(94,113)
(Decrease) increase in cash, cash equivalents, and restricted cash	(1,648)	6,427

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Cash, cash equivalents, and restricted cash at beginning of the period	19,479	12,465
Cash, cash equivalents, and restricted cash at the end of the period	\$17,831	\$18,892

Supplemental disclosure of cash flow information

Cash paid for interest	\$19,784	\$15,052
Cash paid for income taxes	15,177	25,710

Supplemental disclosure of non-cash investing and financing activities

Property and equipment in accounts payable	\$15,435	\$13,476
Property acquired through capital and financing lease obligations	8,911	5,512

The accompanying notes are an integral part of these consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

Sprouts Farmers Market, Inc., a Delaware corporation, through its subsidiaries, operates as a healthy grocery store that offers fresh, natural and organic food through a complete shopping experience that includes fresh produce, bulk foods, vitamins and supplements, packaged groceries, meat and seafood, deli, baked goods, dairy products, frozen foods, beer and wine, natural body care and household items catering to consumers' growing interest in health and wellness. The "Company" is used to refer collectively to Sprouts Farmers Market, Inc. and unless the context otherwise requires, its subsidiaries.

The accompanying unaudited consolidated financial statements include the accounts of the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial statements and are in the form prescribed by the Securities and Exchange Commission in instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company's financial position, results of operations and cash flows for the periods indicated. All material intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for any other interim period or for a full fiscal year. The information included in these consolidated financial statements and notes thereto should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included herein and Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2017 ("fiscal year 2017") included in the Company's Annual Report on Form 10-K, filed on February 22, 2018.

The year-end balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

The Company reports its results of operations on a 52- or 53-week fiscal calendar ending on the Sunday closest to December 31. The fiscal year ending December 30, 2018 ("fiscal year 2018") and fiscal year 2017 are 52-week years. The Company reports its results of operations on a 13-week quarter, except for 53-week fiscal years.

Certain reclassifications of amounts reported in prior periods have been made to conform with the current period presentation.

All dollar amounts are in thousands, unless otherwise noted.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

2. Summary of Significant Accounting Policies

Revenue Recognition

The Company has adopted Accounting Standards Codification (“ASC”) 606, “Revenue from Contracts with Customers” in the first quarter of fiscal year 2018, with a date of initial application of January 1, 2018, using the modified retrospective approach. Comparative information presented has not been adjusted and continues to be reported under ASC 605.

The Company applied ASC 606 to all of its contracts with customers. As a result of the adoption, there is no impact to any financial statement line item, and the Company has recorded no impact to opening retained earnings as of January 1, 2018.

The Company does not have any material contract assets or receivables from contracts with customers, any revenue recognized in the current period from performance obligations satisfied in previous periods, any contract performance obligations, or any material costs to obtain or fulfill a contract as of September 30, 2018. The Company had a net gift card liability balance of \$6.8 million as of September 30, 2018 and \$13.1 million as of December 31, 2017. During the thirty-nine weeks ended September 30, 2018, the Company recognized \$16.1 million in sales related to gift cards redeemed by customers.

Revenue is recognized at the point of sale. The Company’s performance obligations are satisfied upon the transfer of goods to the customer, at the point of sale, and payment from customers is also due at the time of sale. Proceeds from the sale of gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer and the performance obligation is satisfied by the Company.

The nature of goods the Company transfers to customers at the point of sale are inventories, consisting of merchandise purchased for resale.

Restricted Cash

Restricted cash relates to defined benefit plan forfeitures of approximately \$0.7 million and is included in prepaid expenses and other current assets in the consolidated balance sheets.

Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers.” ASU No. 2014-09 provides guidance for revenue recognition. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, and estimating the amount of variable consideration to include in the transaction price attributable to each separate performance obligation. Subsequent to the initial standards, the FASB has also issued several ASUs to clarify specific revenue recognition

topics. The Company adopted ASC 606 effective January 1, 2018 using the modified retrospective approach. As noted above, there is no impact to any financial statement line item as a result of the adoption, and the Company has recorded no impact to opening retained earnings as of January 1, 2018. The Company has added additional disclosures of disaggregated revenue by type in Note 13, "Segments."

In March 2016, the FASB issued ASU No. 2016-04, "Liabilities-Extinguishments of Liabilities (Subtopic 405-20): Recognition of breakage for certain prepaid stored-value products." ASU No. 2016-04 provides a narrow scope exception to the guidance in Subtopic 405-20 to require that stored-value breakage be accounted for consistently with the breakage guidance in Topic 606. The amendments in this update contain specific guidance for derecognition of prepaid stored-value product liabilities, thereby eliminating the current and potential future diversity. The guidance was effective for the Company for its fiscal year 2018. The Company adopted this guidance using the modified retrospective approach. As noted above, there is no impact to any financial statement line item as a result of the adoption, and the Company recorded no impact to opening retained earnings as of January 1, 2018.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This update provides clarifications on the cash flow classification for eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. Adoption of this guidance took place during the first quarter of fiscal year 2018, using the retrospective transition method, and the adoption had no impact on the Company's consolidated financial statements or disclosures.

In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." The amendments in this update require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. Adoption of this guidance took place prospectively during the first quarter of 2018, and the adoption did not have a material impact on the Company's consolidated financial statements or disclosures.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments in this update provide guidance about which changes to the terms or conditions of a share-based award require an entity to apply modification accounting in Topic 718. Adoption of this guidance took place prospectively during the first quarter 2018, and the adoption did not have an impact on the Company's consolidated financial statements or disclosures.

In August 2018, the FASB issued ASU No. 2018-15, "Intangibles — Goodwill and Other — Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract." The amendments in this update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include internal-use software license). The amendments require an entity in a hosting arrangement that is a service contract to follow the guidance in Subtopic 350-40 to determine which service contract implementation costs to capitalize as an asset and which costs to expense. The amendments also require the entity to expense the capitalized implementation costs of a hosting arrangement that is a service contract over the term of the hosting arrangements, which includes reasonably certain renewals. The Company adopted this guidance during the third quarter 2018 using the prospective transition approach. Adoption of the guidance did not have a material impact to the Company's financial statements and resulted in capitalization of implementation costs associated with various technology initiatives which are included in other assets in the consolidated balance sheet as of September 30, 2018.

Recently Issued Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU No. 2016-02, "Leases (ASC 842)." ASU No. 2016-02 requires lessees to recognize a right-of-use asset and corresponding lease liability for all leases with terms greater than twelve months. Recognition, measurement and presentation of expenses will depend on classification as a financing or operating lease. Certain additional quantitative and qualitative disclosures will also be required. This ASU will be effective for the Company beginning with its 2019 fiscal year. While the Company is still evaluating the impact of this ASU, the Company expects it will result in material increases in assets and liabilities in its consolidated balance sheet and enhanced disclosures. In addition, the Company anticipates that the transition of its financing leases to operating leases under the new standard will result in an increase in rent expense, partially offset by reductions to depreciation and interest expense. The Company does not expect that the adoption of the ASU will have an impact on the Company's cash flows.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” The amendments in this update eliminate the second step of the goodwill impairment test and provide that an entity will apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit's carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment. The guidance will be effective for the Company for its fiscal year 2020, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-14, “Compensation —Retirement Benefits —Defined Benefit Plans —General (Subtopic 715-20) —Disclosure Framework —Changes to the Disclosure Requirements for Defined Benefit Plans.” The amendments in this update remove disclosures that no longer are considered cost-beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. The guidance will be effective for the Company for its fiscal year 2020, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's disclosures.

No other new accounting pronouncements issued or effective during the thirty-nine weeks ended September 30, 2018 had, or are expected to have, a material impact on the Company's consolidated financial statements.

3. Fair Value Measurements

The Company records its financial assets and liabilities in accordance with the framework for measuring fair value in accordance with GAAP. This framework establishes a fair value hierarchy that prioritizes the inputs used to measure fair value:

Level 1: Quoted prices for identical instruments in active markets.

Level 2: Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

Level 3: Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

Fair value measurements of nonfinancial assets and nonfinancial liabilities are primarily used in the impairment analysis of goodwill, indefinite-lived intangible assets and long-lived assets.

The following tables present the fair value hierarchy for the Company's financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2018 and December 31, 2017:

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	Level		Level		
September 30, 2018	1	Level 2	3	Total	
Long-term debt	\$ —	\$435,000	\$ —	\$435,000	
Total liabilities	\$ —	\$435,000	\$ —	\$435,000	
Interest rate swap asset	\$ —	\$6,159	\$ —	\$6,159	
Total assets	\$ —	\$6,159	\$ —	\$6,159	

	Level		Level		
December 31, 2017	1	Level 2	3	Total	
Long-term debt	\$ —	\$348,000	\$ —	\$348,000	
Interest rate swap liability	—	1,064	—	1,064	
Total liabilities	\$ —	\$349,064	\$ —	\$349,064	

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

The Company's interest rate swaps are considered Level 2 in the hierarchy and are valued using an income approach. Expected future cash flows are converted to a present value amount based on market expectations of the yield curve on floating interest rates, which is readily available on public markets.

Cash, cash equivalents, and restricted cash, accounts receivable, prepaid expenses and other current assets, accounts payable and other accrued liabilities and, accrued salaries and benefits approximate fair value because of the short maturity of those instruments. Based on comparable open market transactions, the fair value of the long-term debt approximated carrying value as of September 30, 2018 and December 31, 2017.

4. Long-Term Debt

A summary of long-term debt is as follows:

Facility	Maturity	Interest Rate	As of	
			September 30, 2018	December 31, 2017
Senior secured debt				
\$700.0 million Credit Agreement	March 27, 2023	Variable	\$435,000	\$—
Former Credit Facility	April 17, 2020	Variable	—	348,000
Total debt			435,000	348,000
Long-term debt			\$435,000	\$348,000

Senior Secured Revolving Credit Facility

March 2018 Refinancing

On March 27, 2018, the Company's subsidiary, Sprouts Farmers Markets Holdings, LLC ("Intermediate Holdings"), as borrower, entered into an amended and restated credit agreement (the "Amended and Restated Credit Agreement") to amend and restate the Company's existing senior secured credit facility, dated April 17, 2015 (the "Former Credit Facility"). The Amended and Restated Credit Agreement provides for a revolving credit facility with an initial aggregate commitment of \$700.0 million, an increase from \$450.0 million from the Former Credit Facility, which may be increased from time to time pursuant to an expansion feature set forth in the Amended and Restated Credit Agreement.

Concurrently with the closing of the Amended and Restated Credit Agreement, all commitments under the Former Credit Facility were terminated, resulting in a \$0.3 million loss on early extinguishment of debt, recorded in interest

expense during the first quarter of fiscal year 2018. The loss was due to the write-off of a proportional amount of deferred financing costs associated with the Former Credit Facility as the result of certain banks exiting the Amended and Restated Credit Agreement in connection with the refinancing. No amounts were outstanding under the Former Credit Facility as of September 30, 2018.

The Company capitalized debt issuance costs of \$2.1 million related to the refinancing which combined with the remaining \$0.7 million debt issuance costs for the Former Credit Facility, are being amortized on a straight-line basis to interest expense over the five-year term of the Amended and Restated Credit Agreement.

The Amended and Restated Credit Agreement also provides for a letter of credit subfacility and a \$15.0 million swingline facility. Letters of credit issued under the Amended and Restated Credit Agreement reduce its borrowing capacity. Letters of credit totaling \$27.0 million have been issued as of September 30, 2018, primarily to support the Company's insurance programs.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Guarantees

Obligations under the Amended and Restated Credit Agreement are guaranteed by the Company and all of its current and future wholly-owned material domestic subsidiaries (other than the borrower), and are secured by first-priority security interests in substantially all of the assets of the Company and its subsidiary guarantors, including, without limitation, a pledge by the Company of its equity interest in Intermediate Holdings.

Interest and Fees

Loans under the Amended and Restated Credit Agreement initially bear interest at LIBOR plus 1.50% per annum. The interest rate margins are subject to adjustment pursuant to a pricing grid based on the Company's total net leverage ratio, as set forth in the Amended and Restated Credit Agreement. Under the terms of the Amended and Restated Credit Agreement, the Company is obligated to pay a commitment fee on the available unused amount of the commitments between 0.15% to 0.30% per annum, also pursuant to a pricing grid based on the Company's total net leverage ratio.

The interest rate on approximately 57% of outstanding debt under the Amended and Restated Credit Agreement is fixed, reflecting the effects of floating to fixed interest rate swaps (see Note 11, "Derivative Financial Instruments").

Outstanding letters of credit under the Amended and Restated Credit Agreement are subject to a participation fee of 1.50% per annum and an issuance fee of 0.125% per annum.

Payments and Borrowings

The Amended and Restated Credit Agreement is scheduled to mature, and the commitments thereunder will terminate on March 27, 2023, subject to extensions as set forth therein.

The Company may prepay loans and permanently reduce commitments under the Amended and Restated Credit Agreement at any time in agreed-upon minimum principal amounts, without premium or penalty (except LIBOR breakage costs, if applicable).

During fiscal year 2017, the Company borrowed \$153.0 million under the Former Credit Facility to be used in connection with the Company's \$250.0 million share repurchase program (see Note 9, "Stockholders' Equity") and made a total of \$60.0 million of principal payments; resulting in total outstanding debt under the Former Credit Facility of \$348.0 million at December 31, 2017. During the thirty-nine weeks ended September 30, 2018, the Company borrowed an additional \$180.0 million primarily for share repurchases and made a total of \$93.0 million of principal payments; resulting in total outstanding debt under the Amended and Restated Credit Agreement of \$435.0 million as of September 30, 2018.

Covenants

The Amended and Restated Credit Agreement contains financial, affirmative and negative covenants. The negative covenants include, among other things, limitations on the Company's ability to:

- incur additional indebtedness;
- grant additional liens;
- enter into sale-leaseback transactions;
- make loans or investments;
- merge, consolidate or enter into acquisitions;
- pay dividends or distributions;
- enter into transactions with affiliates;

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SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

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- enter into new lines of business;
- modify the terms of debt or other material agreements; and
- change its fiscal year.

Each of these covenants is subject to customary and other agreed-upon exceptions.

In addition, the Amended and Restated Credit Agreement requires that the Company and its subsidiaries maintain a maximum total net leverage ratio not to exceed 3.25 to 1.00 and minimum interest coverage ratio not to be less than 1.75 to 1.00. Each of these covenants is tested on the last day of each fiscal quarter, starting with the fiscal quarter ended September 30, 2018.

The Company was in compliance with all applicable covenants under the Amended and Restated Credit Agreement as of September 30, 2018.

Former Credit Facility

On April 17, 2015, Intermediate Holdings, as borrower, entered into the Former Credit Facility that provided for a revolving credit facility with an initial aggregate commitment of \$450.0 million, subject to an expansion feature set forth therein. The Former Credit Facility also provided for a letter of credit subfacility and a \$15.0 million swingline facility.

The Former Credit Facility was scheduled to mature, and the commitments thereunder were scheduled to terminate, on April 17, 2020.

Loans under the Former Credit Facility bore interest, at the Company's option, either at adjusted LIBOR plus 1.50% per annum, or a base rate plus 0.50% per annum. The interest rate margins were subject to adjustment pursuant to a pricing grid based on the Company's total gross leverage ratio, as defined in the Former Credit Facility. Under the terms of the Former Credit Facility, the Company was obligated to pay a commitment fee on the available unused amount of the commitments equal to 0.20% per annum.

5. Closed Store Reserves

The following is a summary of closed store reserve activity during the thirty-nine weeks ended September 30, 2018 and fiscal year 2017:

Thirty-nine	Fiscal
Weeks Ended	Year Ended
September	December
30,	31,

	2018	2017
Beginning balance	\$ 811	\$ 1,083
Additions	—	—
Usage	(320)	(492)
Adjustments	85	220
Ending balance	\$ 576	\$ 811

Usage relates to lease payments made during the periods for closed stores.

6. Income Taxes

On December 22, 2017, the legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”) was enacted into law, which changed various corporate income tax provisions within the existing Internal Revenue Code. The most significant changes that impacted the Company were the reduction in the corporate federal income tax rate from 35% to 21% and 100% bonus depreciation for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Under the guidance set forth in the SEC's Staff Accounting Bulletin No. 118 ("SAB 118"), the Company may record provisional amounts for the impact of the Tax Act. As of September 30, 2018, the Company has finalized its 2017 federal income tax return and as such completed the accounting for the income tax effects of the 2017 Tax Act. In accordance with SAB 118, any future adjustments required due to changes in interpretation and guidance that may be issued will be recorded as discrete adjustments to income tax expense in the period in which those adjustments become estimable and finalized.

The Company's effective tax rate decreased to 17.3% for the thirteen weeks ended September 30, 2018 from 33.8% for the thirteen weeks ended October 1, 2017 primarily due to the enactment of the Tax Act as disclosed above, as well as the impact of a tax calculation method change. During the quarter ended September 30, 2018 the Company adopted tax calculation method changes that resulted in the accelerated deduction or deferral of certain items. The method changes were included in the Company's 2017 tax return that was finalized during the fiscal quarter. As a result, the Company recorded a \$2.6 million discrete tax benefit in the third quarter of 2018, which decreased the effective tax rate by 5.7%.

The Company's effective tax rate decreased to 16.4% for the thirty-nine weeks ended September 30, 2018 from 31.7% for the thirty-nine weeks ended October 1, 2017 primarily due to the enactment of the Tax Act disclosed above, as well as the recognition of excess tax benefits related to the exercise of stock options recognized in the income tax provision. The tax calculation method change resulted in a discrete rate benefit of 1.5% for the thirty-nine weeks ended September 30, 2018.

Excess tax benefits associated with share-based payment awards are recognized as income tax expense or benefit in the statements of income. The tax effects of exercised or vested awards are treated as discrete items in the reporting period in which they occur. The income tax benefits resulting from excess tax benefits of share-based payment awards were \$1.0 million and \$0.2 million for the thirteen weeks ended September 30, 2018 and October 1, 2017, respectively. The income tax benefits resulting from excess tax benefits of share-based payment awards were \$12.4 million and \$8.4 million for the thirty-nine weeks ended September 30, 2018 and October 1, 2017, respectively.

7. Related-Party Transactions

A member of the Company's board of directors is an investor in a company that is a supplier of coffee to the Company for resale. During the thirteen weeks ended September 30, 2018, there were no purchases from this supplier and \$2.7 million of purchases during the thirteen weeks ended October 1, 2017. During the thirty-nine weeks ended September 30, 2018 and October 1, 2017, purchases from this supplier were \$2.6 million and \$8.1 million, respectively. As of September 30, 2018, the Company had no accounts payable due to this vendor and as of December 31, 2017, the

Company had recorded accounts payable of \$0.7 million.

The Company's former Executive Chairman of the Board, who retired from this position in February 2017, has been the chief executive officer, an equity investor, and lender to a technology supplier to the Company. During the thirteen weeks ended September 30, 2018 and October 1, 2017, purchases from this supplier and its predecessors were \$1.8 million and \$1.6 million, respectively. During the thirty-nine weeks ended September 30, 2018 and October 1, 2017, purchases from this supplier and its predecessors were \$4.4 million and \$5.2 million, respectively. As of September 30, 2018, and December 31, 2017, the Company had recorded accounts payable due to the supplier of \$0.2 million and \$0.1 million, respectively.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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8. Commitments and Contingencies

The Company is exposed to claims and litigation matters arising in the ordinary course of business and uses various methods to resolve these matters that are believed to best serve the interests of the Company's stakeholders. The Company's primary contingencies are associated with self-insurance obligations and litigation matters. Self-insurance liabilities require significant judgment and actual claim settlements and associated expenses may differ from the Company's current provisions for loss.

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against the Company and certain of its directors and officers on behalf of a purported class of purchasers of shares of the Company's common stock in the Company's underwritten secondary public offering which closed on March 10, 2015 (the "March 2015 Offering"). The complaint purports to state claims under Sections 11, 12 and 15 of the Securities Act of 1933, as amended, based on an alleged failure by the Company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint seeks damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. After removal to federal court, the plaintiff sought remand, which the court granted in March 2017. On May 25, 2017, the Company filed a Motion to Dismiss in the Superior Court for the State of Arizona, which the court granted in part and denied in part by order entered August 30, 2017. The Company answered the complaint on September 28, 2017. On August 15, 2018, the Company reached an agreement in principle to settle these claims. The parties' settlement agreement will be presented to the court for approval. If approved by the court, the settlement will be funded from the Company's directors and officers liability insurance policy and will not have a material impact on the Company's consolidated financial statements.

9. Stockholders' Equity

Share Repurchases

The following table outlines the common stock share repurchase programs authorized by the Company's board of directors from time to time, and the related repurchase activity and available authorization as of September 30, 2018.

		Amount	Cost of	Authorization
Effective date	Expiration date	authorized	repurchases	available
November 4, 2015	November 4, 2017	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	\$ 250,000	\$ 250,000	\$ —
February 20, 2017	December 31, 2018	\$ 250,000	\$ 250,000	\$ —
February 20, 2018	December 31, 2019	\$ 350,000	\$ 66,707	\$ 283,293

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

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The shares under the Company's repurchase programs may be purchased on a discretionary basis from time to time prior to the applicable expiration date, subject to general business and market conditions and other investment opportunities, through open market purchases, privately negotiated transactions, or other means, including through Rule 10b5-1 trading plans. The board's authorization of the share repurchase programs does not obligate the Company to acquire any particular amount of common stock, and the repurchase programs may be commenced, suspended, or discontinued at any time. The Company has used borrowings under its Former Credit Facility and Amended and Restated Credit Agreement to assist with the repurchase programs (see Note 4, "Long-Term Debt").

Share repurchase activity under the Company's repurchase programs for the periods indicated was as follows (total cost in thousands):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	September 30,	October 1,	September 30,	October 1,
	2018	2017	2018	2017
Number of common shares acquired	719,004	3,249,204	8,411,575	9,136,468
Average price per common share acquired	\$21.29	\$22.16	\$22.98	\$21.01
Total cost of common shares acquired	\$15,307	\$72,000	\$193,307	\$192,000

Shares purchased under the Company's repurchase programs were subsequently retired.

10. Net Income Per Share

The computation of net income per share is based on the number of weighted average shares outstanding during the period. The computation of diluted net income per share includes the dilutive effect of share equivalents consisting of incremental shares deemed outstanding from the assumed exercise of options, assumed vesting of restricted stock units ("RSUs"), assumed vesting of performance stock awards ("PSAs"), and assumed vesting of restricted stock awards ("RSAs").

A reconciliation of the numerators and denominators of the basic and diluted net income per share calculations is as follows (in thousands, except per share amounts):

Thirteen Weeks Ended	Thirty-nine Weeks Ended
----------------------	-------------------------

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	September 30, 2018	October 1, 2017	September 30, 2018	October 1, 2017
Basic net income per share:				
Net income	\$37,500	\$31,486	\$145,833	\$118,741
Weighted average shares outstanding	126,855	134,320	129,572	136,063
Basic net income per share	\$0.30	\$0.23	\$1.13	\$0.87
Diluted net income per share:				
Net income	\$37,500	\$31,486	\$145,833	\$118,741
Weighted average shares outstanding - basic	126,855	134,320	129,572	136,063
Dilutive effect of equity-based awards:				
Assumed exercise of options to purchase shares	341	2,128	484	2,506
RSUs	175	122	193	124
RSAs	82	114	137	102
PSAs	174	86	151	65
Weighted average shares and equivalent				
shares outstanding	127,627	136,770	130,537	138,860
Diluted net income per share	\$0.29	\$0.23	\$1.12	\$0.86

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

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For the thirteen weeks ended September 30, 2018, the computation of diluted net income per share does not include 0.7 million options and 0.1 million PSAs as those awards would have been antidilutive or were performance awards with performance conditions not yet deemed met. For the thirteen weeks ended October 1, 2017, the computation of diluted net income per share does not include 1.9 million options and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

For the thirty-nine weeks ended September 30, 2018, the computation of diluted net income per share does not include 1.1 million options and 0.1 million PSAs those awards would have been antidilutive or were performance awards with performance conditions not yet deemed met. For the thirty-nine weeks ended October 1, 2017, the computation of diluted net income per share does not include 1.9 million options and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

11. Derivative Financial Instruments

The Company entered into an interest rate swap agreement in December 2017 to manage its cash flow associated with variable interest rates. This forward contract has been designated and qualifies as a cash flow hedge, and its change in fair value is recorded as a component of other comprehensive income and reclassified into earnings in the same period or periods in which the forecasted transaction occurs. The forward contract consists of five cash flow hedges. To qualify as a hedge, the Company needs to formally document, designate and assess the effectiveness of the transactions that receive hedge accounting.

The notional dollar amount of the five outstanding swaps was \$250.0 million at September 30, 2018 and December 31, 2017, respectively, under which the Company pays a fixed rate and received a variable rate of interest (cash flow swap). The cash flow swaps hedge the change in interest rates on debt related to fluctuations in interest rates and each have a length of one year and mature annually from 2018 to 2022. These interest rate swaps have been designated and qualify as cash flow hedges and have met the requirements to assume zero ineffectiveness. The Company reviews the effectiveness of its hedging instruments on a quarterly basis.

The counterparties to these derivative financial instruments are major financial institutions. The Company evaluates the credit ratings of the financial institutions and believes that credit risk is at an acceptable level.

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	September 30, 2018		December 31, 2017	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as				
hedging instruments				
	Other Current Assets		Other Accrued Liabilities	
Interest rate swaps	and Other Assets	\$6,159	and Long-term Liabilities	\$1,064

The gain or loss on these derivative instruments is recognized in other comprehensive income, net of tax, with the portion related to current period interest payments reclassified to interest expense on the consolidated statements of income.

	Thirteen Weeks Ended	Thirteen Weeks Ended	Thirty-nine Weeks Ended	Thirty-nine Weeks Ended
	September 30, 2018	October 1, 2017	September 30, 2018	October 1, 2017
Consolidated Statements of				
Income Classification				
Interest income (expense), net	\$ 176	\$ —	\$ 115	\$ —

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

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12. Comprehensive Income

During the thirty-nine weeks ended October 1, 2017, the Company did not record accumulated other comprehensive income. The following table presents the changes in accumulated other comprehensive income for the thirty-nine weeks ended September 30, 2018.

	Cash Flow	Hedges
Balance at December 31, 2017		\$(784)
Other comprehensive income, net of tax		
Unrealized gain on cash flow hedging activities, net of		
income tax of \$1,851	5,351	
Total other comprehensive income	5,351	
Balance at September 30, 2018	\$4,567	

Amounts reclassified from accumulated other comprehensive income (loss) are included within interest expense on the consolidated statements of income.

13. Segments

The Company has one reportable and one operating segment, healthy grocery stores.

In accordance with ASC 606, the following table represents a disaggregation of revenue for the thirteen and thirty-nine weeks ended September 30, 2018 and October 1, 2017.

	Thirteen Weeks Ended			
	September 30, 2018		October 1, 2017	
Perishables	\$777,413	58.5 %	\$710,250	58.9 %
Non-Perishables	551,696	41.5 %	495,809	41.1 %
Net Sales	\$1,329,109	100.0 %	\$1,206,059	100.0 %

Thirty-nine Weeks Ended

	September 30, 2018			October 1, 2017		
Perishables	\$2,283,348	58.0 %		\$2,060,367	58.5 %	
Non-Perishables	1,654,650	42.0 %		1,460,312	41.5 %	
Net Sales	\$3,937,998	100.0 %		\$3,520,679	100.0 %	

The Company categorizes the varieties of products it sells as perishable and non-perishable. Perishable product categories include produce, meat, seafood, deli, bakery, floral and dairy and dairy alternatives. Non-perishable product categories include grocery, vitamins and supplements, bulk items, frozen foods, beer and wine, and natural health and body care.

14. Equity-Based Compensation

2013 Incentive Plan

The Company's board of directors adopted, and its equity holders approved, the Sprouts Farmers Market, Inc. 2013 Incentive Plan (the "2013 Incentive Plan"). The 2013 Incentive Plan became effective July 31, 2013 in connection with the Company's initial public offering and replaced the 2011 Option Plan (as defined below) (except with respect to outstanding options under the 2011 Option Plan). The 2013 Incentive Plan serves as the umbrella plan for the Company's stock-based and cash-based incentive compensation programs for its directors, officers and other team members, including RSUs, PSAs, and RSAs. On May 1, 2015, the Company's stockholders approved the material terms of the performance goals under the 2013 Incentive Plan for purposes of Section 162(m) of the Internal Revenue Code.

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The aggregate number of shares of common stock that may be issued to team members and directors under the 2013 Incentive Plan may not exceed 10,089,072. Shares subject to awards granted under the 2013 Incentive Plan which are subsequently forfeited, expire unexercised or are otherwise not issued will not be treated as having been issued for purposes of the share limitation. As of September 30, 2018, there were 3,025,033 stock awards outstanding and 5,205,689 shares remaining available for issuance under the 2013 Incentive Plan.

2011 Option Plan

In May 2011, the Company adopted the Sprouts Farmers Markets, LLC Option Plan (the “2011 Option Plan”) to provide team members or directors of the Company with options to acquire shares of the Company. The Company had authorized 12,100,000 shares for issuance under the 2011 Option Plan. Options may no longer be issued under the 2011 Option Plan. As of September 30, 2018, there were 130,643 options outstanding under the 2011 Option Plan.

Awards Granted

During the thirty-nine weeks ended September 30, 2018, the Company granted the following stock-based compensation awards:

Grant Date	RSUs	PSAs
March 2018	451,951	126,098
May 2018	54,913	2,756
August 2018	8,732	—
Total:	515,596	128,854
Weighted-average grant date fair value	\$24.80	\$25.10
Weighted-average exercise price	—	—

Stock Options

The Company uses the Black-Scholes option pricing model to estimate the fair value of options at grant date. Options vest in accordance with the terms set forth in the grant letter and vary depending on if they are time-based or performance-based.

Time-based options granted prior to fiscal year 2016 generally vest ratably over a period of 12 quarters (three years), and time-based options granted in fiscal year 2016 vest annually over a period of three years. No options have been granted subsequent to 2016.

RSUs

The fair value of RSUs is based on the closing price of the Company’s common stock on the grant date. RSUs generally vest annually over a period of two or three years from the grant date.

PSAs

PSAs granted in fiscal year 2015 are restricted shares that were subject to the Company achieving certain earnings per share performance targets, as well as additional time-vesting conditions. The fair value of PSAs is based on the closing price of the Company's common stock on the grant date. The performance conditions with respect to 2015 earnings per share targets were deemed to have been met, and all PSAs have vested. During the thirty-nine weeks ended September 30, 2018, 20,595 of the 2015 PSAs were vested, and during the thirty-nine weeks ended October 1, 2017, 21,050 of the 2015 PSAs were vested.

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PSAs granted in fiscal year 2016 are restricted shares that are subject to the Company achieving certain earnings before interest and taxes (“EBIT”) performance targets on an annual and cumulative basis over a three-year performance period, as well as additional time-vesting conditions. The EBIT target for each of the three years during the performance period is based on a percentage increase over the previous year’s actual EBIT, with each annual performance tranche measured independently of the previous and next tranche. Cumulative performance is based on the aggregate annual performance and is measured against a cumulative performance target. Payout of the performance shares will either be 0% or range from 50% to 150% of the target number of shares granted, depending upon goal achievement. Although deemed unlikely to be met, if the performance conditions are met, the applicable number of performance shares is subject to cliff vesting on the third anniversary of the grant date (March 2019). The performance conditions with respect to 2016 and 2017 EBIT were not met.

PSAs granted in March 2017 were subject to the Company achieving certain earnings per share performance targets during 2017. The criteria is based on a range of performance targets in which grantees may earn between 10% and 150% of the base number of awards granted. The performance conditions with respect to 2017 earnings per share were deemed to have been met, and the PSAs will vest 50% on the second anniversary of the grant date (2019) and 50% on the third anniversary of the grant date (2020).

PSAs granted in March 2018 are subject to the Company achieving certain EBIT performance targets for the 2020 fiscal year. The criteria is based on a range of performance targets in which grantees may earn 0% to 200% of the base number of awards granted. If performance conditions are met, the applicable number of performance shares will vest on the third anniversary of the grant date (2021).

RSAs

The fair value of RSAs is based on the closing price of the Company’s common stock on the grant date. Outstanding RSA grants vest annually over three years.

Equity-based Compensation Expense

Equity-based compensation expense was reflected in the consolidated statements of income as follows:

Thirteen Weeks Ended		Thirty-nine Weeks Ended	
September	October	September	October
30,	1,	30,	1,
2018	2017	2018	2017

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Cost of sales, buying and occupancy	\$251	\$265	\$827	\$777
Direct store expenses	339	349	1,063	1,098
Selling, general and administrative expenses	2,453	3,471	9,783	8,450
Equity-based compensation expense before				
income taxes	3,043	4,085	11,673	10,325
Income tax benefit	(782)	(1,528)	(3,000)	(3,863)
Net equity-based compensation expense	\$2,261	\$2,557	\$8,673	\$6,462

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The following equity-based awards were outstanding as of September 30, 2018 and December 31, 2017:

	As of September 30, 2018	As of December 31, 2017
	(in thousands)	
Options		
Vested	1,816	4,226
Unvested	98	464
RSUs	694	449
PSAs	366	231
RSAs	182	353

As of September 30, 2018, total unrecognized compensation expense and remaining weighted average recognition period related to outstanding equity-based awards was as follows:

	Unrecognized compensation expense	Remaining weighted average recognition period
Options	\$ 360	0.4
RSUs	11,895	1.8
PSAs	3,834	1.4
RSAs	2,343	1.4
Total unrecognized compensation expense		
at September 30, 2018	\$ 18,432	

During the thirty-nine weeks ended September 30, 2018 and October 1, 2017, the Company received \$21.1 million and \$6.6 million, respectively, in cash proceeds from the exercise of options.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

You should read the following discussion of our financial condition and results of operations together with the consolidated financial statements and related notes that are included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K filed for the 2017 fiscal year, February 22, 2018 with the Securities and Exchange Commission. All dollar amounts included below are in thousands, unless otherwise noted.

Business Overview

Sprouts Farmers Market operates as a healthy grocery store that specializes in fresh, natural and organic products at prices that appeal to everyday grocery shoppers. Based on the belief that healthy food should be affordable, Sprouts' welcoming environment and knowledgeable team members continue to drive its growth. Sprouts offers a complete shopping experience that includes an array of fresh produce in the heart of the store, a deli with prepared entrees and side dishes, The Butcher Shop, The Fish Market, an expansive vitamins and supplements department and more. Since our founding in 2002, we have grown rapidly, significantly increasing our sales, store count and profitability. With 313 stores in 19 states as of September 30, 2018, we are one of the largest specialty retailers of fresh, natural and organic food in the United States. As of October 29, 2018, we have grown to 315 stores in 19 states.

At Sprouts, we believe healthy living is a journey and every meal is a choice. The cornerstones of our business are fresh, natural and organic products at compelling prices (which we refer to as "Healthy Living for Less"), an attractive and differentiated shopping experience featuring a broad selection of innovative healthy products, and knowledgeable team members who we believe provide best-in-class customer engagement and product education.

Our Heritage

In 2002, we opened the first Sprouts Farmers Market store in Chandler, Arizona. From our founding in 2002 through September 30, 2018, we continued to open new stores while successfully rebranding 43 Henry's Farmers Market and 39 Sunflower Farmers Market stores added in 2011 and 2012, respectively, through acquisitions to the Sprouts banner. These three businesses all trace their lineage back to Henry's Farmers Market and were built with similar store formats and operations including a strong emphasis on value, produce and service in smaller, convenient locations. The consistency of these formats and operations was an important factor that allowed us to rapidly and successfully rebrand and integrate each of these businesses under the Sprouts banner and on a common platform.

Outlook

We are pursuing a number of strategies designed to continue our growth, including expansion of our store base, continuing positive comparable store sales and growing the Sprouts brand. We intend to continue expanding our store base by pursuing new store openings in our existing markets, expanding into adjacent markets and penetrating new markets. Although we plan to expand our store base primarily through new store openings, we may grow through strategic acquisitions if we identify suitable targets and are able to negotiate acceptable terms and conditions for acquisition. We intend to open approximately 30 new stores per year for the near term, and in 2018, we have opened 30 new stores through October 29, 2018.

We also believe we can continue to deliver positive comparable store sales growth by enhancing our core value proposition and distinctive customer-oriented shopping experience, as well as through expanding and refining our fresh, natural and organic product offerings, our targeted and personalized marketing efforts and our in-store education. We are committed to growing the Sprouts brand by supporting our stores, product offerings and corporate partnerships, including the expansion of innovative marketing and promotional strategies through print, digital and

social media platforms.

Results of Operations for Thirteen Weeks Ended September 30, 2018 and October 1, 2017

The following tables set forth our unaudited results of operations and other operating data for the periods presented. The period-to-period comparison of financial results is not necessarily indicative of financial results to be achieved in future periods. All dollar amounts are in thousands, unless otherwise noted.

	Thirteen weeks ended	
	September 30, 2018	October 1, 2017
Unaudited Quarterly Consolidated Statement of Income Data:		
Net sales	\$1,329,109	\$1,206,059
Cost of sales, buying and occupancy	946,734	859,650
Gross profit	382,375	346,409
Direct store expenses	281,365	250,191
Selling, general and administrative expenses	43,944	39,955
Store pre-opening costs	3,819	2,456
Store closure and other costs	461	803
Income from operations	52,786	53,004
Interest expense	(7,419)	(5,609)
Other income	—	162
Income before income taxes	45,367	47,557
Income tax provision	(7,867)	(16,071)
Net income	\$37,500	\$31,486
Weighted average shares outstanding	126,855	134,320
Diluted effect of equity-based awards	772	2,450
Weighted average shares and equivalent shares outstanding	127,627	136,770
Diluted net income per share	\$0.29	\$0.23

	Thirteen weeks ended	
	September 30, 2018	October 1, 2017
Other Operating Data:		
Comparable store sales growth	1.5 %	4.6 %
Stores at beginning of period	301	274
Closed	—	—
Opened	12	8
Stores at end of period	313	282

Comparison of Thirteen Weeks Ended September 30, 2018 to Thirteen Weeks Ended

October 1, 2017

Net sales

	Thirteen weeks ended			
	September 30, 2018	October 1, 2017	Change	% Change
Net sales	\$1,329,109	\$1,206,059	\$123,050	10 %
Comparable store sales growth	1.5 %	4.6 %		

Net sales during the thirteen weeks ended September 30, 2018 totaled \$1.3 billion, increasing 10% over the same period of the prior fiscal year. Sales growth was driven by strong performance in new stores opened and a 1.5% increase in comparable store sales. Comparable stores contributed approximately 90% of total sales for the thirteen weeks ended September 30, 2018 and approximately 87% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirteen weeks ended			
	September 30, 2018	October 1, 2017	Change	% Change
Net sales	\$1,329,109	\$1,206,059	\$123,050	10 %
Cost of sales, buying and occupancy	946,734	859,650	87,084	10 %
Gross profit	382,375	346,409	35,966	10 %
Gross margin	28.77 %	28.72 %	0.05 %	

Gross profit increased during the thirteen weeks ended September 30, 2018 compared to the thirteen weeks ended October 1, 2017 by \$36.0 million, of which \$35.4 million was a result of increased sales volume and \$0.6 million related to increased margin rate. This improvement was primarily driven by higher margin rates for new stores opened in the current period partially offset by higher occupancy costs.

Direct store expenses

	Thirteen weeks ended			
	September 30, 2018	October 1, 2017	Change	% Change

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Direct store expenses	\$281,365		\$250,191		\$31,174	12	%
Percentage of net sales	21.2	%	20.7	%	0.5	%	

Direct store expenses for the thirteen weeks ended September 30, 2018 increased \$31.2 million, including \$24.5 million related to stores opened after October 1, 2017, and \$6.7 million related to stores operating prior to the same period in 2017. Direct store expenses, as a percentage of net sales, increased 50 basis points. This deleverage is primarily driven by planned wage investments funded by the savings from the legislation commonly referred to as the Tax Cuts and Jobs Act (the “Tax Act”) as well as increased healthcare costs and higher depreciation expense associated with new store and strategic initiatives.

Selling, general and administrative expenses

	Thirteen weeks ended				
	September 30, 2018		October 1, 2017		
			Change	% Change	
Selling, general and administrative					
expenses	\$43,944	\$39,955	\$3,989	10	%
Percentage of net sales	3.3	%	3.3	%	—

Selling, general and administrative expenses, as a percentage of sales, remained consistent during the thirteen weeks ended September 30, 2018 as compared to the thirteen weeks ended October 1, 2017. The \$4.0 million increase in selling, general and administrative expenses primarily relates to increases in advertising, consulting and compensation expense in line with store growth and the Company's strategic initiatives, partially offset by lower bonus and stock-based compensation expense.

Store pre-opening costs

	Thirteen weeks ended					
	September		October			
	30,	1, 2017	Change	% Change		
	2018					
Attributable to 2017 store openings	—	2,055	(2,055)			
Attributable to planned 2018 store openings	3,505	139	3,366			
Attributable to planned 2019 store openings	314	262	52			
Total store pre-opening costs	\$3,819	\$2,456	\$1,363	55	%	
Percentage of net sales	0.3	%	0.2	%	0.1	%

Store pre-opening costs in the thirteen weeks ended September 30, 2018 included \$3.5 million primarily related to 12 stores opening during the period and two additional stores planned to be open in 2018 and \$0.3 million associated with stores expected to open in 2019. Store pre-opening costs in the thirteen weeks ended October 1, 2017 included \$2.1 million related to opening 11 stores during the third and fourth quarter 2017 and \$0.4 million associated with stores opened subsequent to 2017.

Store closure and other costs

Store closure costs for the thirteen weeks ended September 30, 2018 and October 1, 2017 are related to adjustments to the closed facility reserve primarily related to refinement of estimated subtenant income and other actual occupancy costs from original estimates.

During the third quarter 2018, we incurred \$0.4 million in costs, net of estimated insurance recovery, primarily associated with Hurricane Florence which affected 24 stores in three states. Although physical damage was minimal, the stores incurred costs for hurricane preparation work, temporary closures and inventory loss.

During the third quarter of 2017, 14 of our stores were affected by hurricanes in three states. Although physical damage was minimal, the stores experienced loss of business due to temporary closures, inventory loss and additional expenses to clean up and power the stores. These costs, net of estimated insurance recovery, approximate \$0.7 million in the thirteen weeks ended October 1, 2017.

Interest expense

	Thirteen weeks ended September 30,		October 1, 2017	Change	% Change	
	2018					
Long-term debt	\$4,312		\$ 2,305	\$ 2,007	87	%
Capital and financing leases	3,023		3,033	(10)	(0)	%
Deferred financing costs	141		116	25	22	%
Interest rate hedge and other	(57)		155	(212)	(137)	%
Total Interest Expense	\$7,419		\$ 5,609	\$ 1,810	32	%

The increase in interest expense is due to the higher principal balance on long-term debt combined with slightly higher interest rates for the thirteen weeks ended September 30, 2018.

Income tax provision

Income tax provision differed from the amounts computed by applying the U.S. federal income tax rate to pretax income as a result of the following:

	Thirteen weeks ended	
	September 30, 2018	October 1, 2017
Federal statutory rate	21.0 %	35.0 %
Increase (decrease) in income taxes resulting from:		
State income taxes, net of federal benefit	4.9 %	3.7 %
Excess tax benefits from share based payments	(2.1)%	(0.5)%
Tax calculation method change	(5.7)%	—
Other, net	(0.8)%	(4.4)%
Effective tax rate	17.3 %	33.8 %

Income tax provision decreased to \$7.9 million for the thirteen weeks ended September 30, 2018 from \$16.1 million for the thirteen weeks ended October 1, 2017. Our effective income tax rate decreased to 17.3% in the thirteen weeks ended September 30, 2018 from 33.8% in the thirteen weeks ended October 1, 2017 primarily related to the effects of the Tax Act, a discrete rate benefit resulting from a tax calculation method change made in connection with finalizing the 2017 income tax return and the recognition of excess tax benefits related to the exercise of stock options.

Net income

	Thirteen weeks ended			
	September 30, 2018		October 1, 2017	
	2018	1, 2017	Change	% Change
Net income	\$37,500	\$31,486	\$6,014	19 %
Percentage of net sales	2.8 %	2.6 %	0.2 %	

Net income increased \$6.0 million as a result of increased sales, due to strong new store performance and lower tax rate due to the Tax Act and tax accounting method change, partially offset by higher compensation expenses due to planned wage investments funded by the savings from the Tax Act.

Diluted earnings per share

	Thirteen weeks ended				
	September 30, 2018	October 1, 2017	Change	% Change	
Diluted earnings per share	\$0.29	\$0.23	\$0.06	26	%
Diluted weighted average shares					
outstanding	127,627	136,770	(9,143)		

The increase in diluted earnings per share of \$0.06 was driven by higher net income and fewer diluted shares outstanding compared to the prior year, due primarily to the share repurchase program.

Results of Operations for Thirty-nine Weeks Ended September 30, 2018 and October 1, 2017

The following tables set forth our unaudited results of operations and other operating data for the periods presented. The period-to-period comparison of financial results is not necessarily indicative of financial results to be achieved in future periods. All dollar amounts are in thousands, unless otherwise noted.

	Thirty-nine weeks ended	
	September 30, 2018	October 1, 2017
Unaudited Quarterly Consolidated Statement of Income Data:		
Net sales	\$3,937,998	\$3,520,679
Cost of sales, buying and occupancy	2,788,159	2,494,998
Gross profit	1,149,839	1,025,681
Direct store expenses	816,933	715,336
Selling, general and administrative expenses	128,828	110,312
Store pre-opening costs	9,414	10,055
Store closure and other costs	497	992
Income from operations	194,167	188,986
Interest expense	(20,028)	(15,447)
Other income	325	388
Income before income taxes	174,464	173,927
Income tax provision	(28,631)	(55,186)
Net income	\$145,833	\$118,741
Weighted average shares outstanding	129,572	136,063
Diluted effect of equity-based awards	965	2,797
Weighted average shares and equivalent shares outstanding	130,537	138,860
Diluted net income per share	\$1.12	\$0.86

	Thirty-nine weeks ended	
	September 30, 2018	October 1, 2017
Other Operating Data:		
Comparable store sales growth	2.0 %	2.4 %
Stores at beginning of period	285	253
Closed	—	—
Opened	28	29
Stores at end of period	313	282

Comparison of Thirty-nine Weeks Ended September 30, 2018 to Thirty-nine Weeks Ended

October 1, 2017

Net sales

	Thirty-nine weeks ended				
	September	October 1,		Change	% Change
	30, 2018	2017			
Net sales	\$3,937,998	\$3,520,679		\$417,319	12 %
Comparable store sales growth	2.0	% 2.4		%	

Net sales during the thirty-nine weeks ended September 30, 2018 totaled \$3.9 billion, increasing 12% over the same period of the prior fiscal year. Sales growth was primarily driven by strong performance in new stores opened and a 2.0% increase in comparable store sales. Comparable stores contributed approximately 89% of net sales for the thirty-nine weeks ended September 30, 2018 and approximately 87% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirty-nine weeks ended				
	September	October 1,		Change	% Change
	30, 2018	2017			
Net sales	\$3,937,998	\$3,520,679		\$417,319	12 %
Cost of sales, buying and occupancy	2,788,159	2,494,998		293,161	12 %
Gross profit	1,149,839	1,025,681		124,158	12 %
Gross margin	29.20	% 29.13		% 0.07	%

Gross profit increased during the thirty-nine weeks ended September 30, 2018 compared to the thirty-nine weeks ended October 1, 2017 by \$124.2 million, primarily as a result of increased sales volume due in part to the opening of 28 new stores and increased margin rate.

Direct store expenses

	Thirty-nine weeks ended			
	September	October		
	30, 2018	1, 2017	Change	% Change

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Direct store expenses	\$816,933		\$715,336		\$101,597	14	%
Percentage of net sales	20.7	%	20.3	%	0.4		%

Direct store expenses for the thirty-nine weeks ended September 30, 2018 increased \$101.6 million. Direct store expenses, as a percentage of net sales, increased 40 basis points. This deleverage is primarily driven by planned wage investments funded by the savings from the Tax Act as well as increased healthcare costs and depreciation expense associated with new store and strategic initiatives.

Selling, general and administrative expenses

	Thirty-nine weeks ended					
	September 30, 2018	October 1, 2017	Change	% Change		
Selling, general and administrative expenses	\$128,828	\$110,312	\$18,516	17	%	
Percentage of net sales	3.3	% 3.1	% 0.2	%		

The increase in selling, general and administrative expenses primarily reflects increases in compensation expense, advertising and consulting costs, commensurate with store growth and strategic initiatives.

Store pre-opening costs

	Thirty-nine weeks ended			
	September			
	30,	October		
	2018	1, 2017	Change	% Change
Attributable to 2017 store openings	—	9,272	(9,272)	
Attributable to planned 2018 store openings	8,416	254	8,162	
Attributable to planned 2019 store openings	998	529	469	
Total store pre-opening costs	\$9,414	\$10,055	\$(641)	(6)%
Percentage of net sales	0.2 %	0.3 %	(0.1)%	

Store pre-opening costs in the thirty-nine weeks ended September 30, 2018 included \$8.4 million primarily related to 28 stores opening during the period and two additional stores planned to be open in 2018 and \$1.0 million associated with stores expected to open in 2019. Store pre-opening costs in the thirty-nine weeks ended October 1, 2017 included \$9.3 million related to opening 32 stores during the year and \$0.8 million associated with stores opened subsequent to 2017.

Store closure and other costs

Store closure costs for the thirty-nine weeks ended September 30, 2018 and October 1, 2017 are related to adjustments to the closed facility reserve primarily related to refinement of estimated subtenant income and other actual occupancy costs from original estimates.

During the third quarter 2018, we incurred \$0.4 million in costs, net of estimated insurance recovery, primarily associated with Hurricane Florence which affected 24 stores in three states. Although physical damage was minimal, the stores incurred costs for hurricane preparation work, temporary closures and inventory loss.

During the third quarter of 2017, 14 of our stores were affected by hurricanes in three states. Although physical damage was minimal, the stores experienced loss of business due to temporary closures, inventory loss and additional expenses to clean up and power the stores. These costs, net of estimated insurance recovery, approximate \$0.7 million in the thirty-nine weeks ended October 1, 2017.

Interest expense

	Thirty-nine weeks ended			
	September			
	30,	October		
	2018	1, 2017	Change	% Change
Long-term debt	\$10,495	\$5,919	\$4,576	77 %

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Capital and financing leases	8,748	8,715	33	0	%
Deferred financing costs	658	347	311	90	%
Interest rate hedge and other	127	466	(339)	(73)	%
Total Interest Expense	\$20,028	\$15,447	\$4,581	30	%

The increase in interest expense is due to the higher principal balance of long-term debt combined with slightly higher interest rates on our Former Credit Facility for the thirty-nine weeks ended September 30, 2018.

Income tax provision

Income tax provision differed from the amounts computed by applying the U.S. federal income tax rate to pretax income as a result of the following:

	Thirty-nine weeks ended September 30, 2018 October 1, 2017			
Federal statutory rate	21.0%	35.0	%	
Decrease in income taxes resulting from:				
State income taxes, net of federal benefit	4.9 %	3.7	%	
Excess tax benefits from share based payments	(7.1)%	(4.9	)%	
Tax calculation method change	(1.5)%	—		
Other, net	(0.9)%	(2.1	)%	
Effective tax rate	16.4%	31.7	%	

Income tax provision decreased to \$28.6 million for the thirty-nine weeks ended September 30, 2018 from \$55.2 million for the thirty-nine weeks ended October 1, 2017. Our effective income tax rate decreased to 16.4% in the thirty-nine weeks ended September 30, 2018 from 31.7% in the thirty-nine weeks ended October 1, 2017 primarily related to the effects of the Tax Act, the recognition of excess tax benefits related to the exercise of stock options and a discrete rate benefit resulting from a tax calculation method change made in connection with finalizing the 2017 income tax return.

Net income

	Thirty-nine weeks ended September 30, 2018 October 1, 2017					
	September 30, 2018	October 1, 2017	Change	% Change		
Net income	\$145,833	\$118,741	\$27,092	23	%	
Percentage of net sales	3.7 %	3.4 %	0.3	%		

Net income increased \$27.1 million as a result of increased sales, due to strong new store performance and lower tax rate due primarily to the Tax Act, partially offset higher compensation expenses due to planned wage investments funded by the savings from the Tax Act.

Diluted earnings per share

	Thirty-nine weeks ended				
	September 30, 2018	October 1, 2017	Change	% Change	
Diluted earnings per share	\$1.12	\$0.86	\$0.26	30	%
Diluted weighted average shares					
outstanding	130,537	138,860	(8,323)		

The increase in diluted earnings per share of \$0.26 was driven by the increase in net income as well as fewer diluted shares outstanding compared to the prior year, due primarily to the share repurchase program.

Return on Invested Capital

In addition to reporting financial results in accordance with generally accepted accounting principles, or GAAP, we provide information regarding Return on Invested Capital (referred to as “ROIC”) as additional information about our operating results. ROIC is a non-GAAP financial measure and should not be reviewed in isolation or considered as a substitute for our financial results as reported in accordance with GAAP. ROIC is an important measure used by management to evaluate our investment returns on capital and provides a meaningful measure of the effectiveness of our capital allocation over time.

We define ROIC as net operating profit after tax (referred to as “NOPAT”), including the effect of capitalized operating leases, divided by average invested capital. Operating leases are capitalized as part of the ROIC calculation to control for differences in capital structure between us and our competitors. Capitalized operating lease interest represents this adjustment to NOPAT and is calculated by the hypothetical capitalization of our operating leases, using eight times our trailing twelve months rent expense and an interest rate factor of seven percent. Operating leases are determined as the trailing twelve months’ rent expense times a factor of eight. Invested capital reflects a trailing twelve-month average.

As numerous methods exist for calculating ROIC, our method may differ from methods used by other companies to calculate their ROIC. It is important to understand the methods and the differences in those methods used by other companies to calculate their ROIC before comparing our ROIC to that of other companies.

Our calculation of ROIC for the fiscal periods indicated was as follows:

	Rolling Four Quarters Ended September 30, October 1,			
	2018	2017		
	(dollars in thousands)			
Net income (1)	\$185,531	\$135,745		
Income Tax Adjustment for Tax Act (2)	(21,266)	—		
Interest expense, net of tax (3)	20,534	11,770		
Net operating profit after tax (NOPAT)	\$184,799	\$147,515		
Total rent expense, net of tax (3)	104,958	78,113		
Estimated depreciation on capitalized operating leases, net of tax (3)	(46,182)	(34,370)		
Estimated interest on capitalized operating leases, net of tax (3) (4)	58,776	43,743		
NOPAT, including effect of capitalized operating leases	\$243,575	\$191,258		
Average working capital	21,536	15,093		
Average property and equipment	738,424	641,451		
Average other assets	573,946	574,281		
Average other liabilities	(192,287)	(149,039)		
Average invested capital	\$1,141,619	\$1,081,786		
Average estimated asset base of capitalized operating leases	1,053,271	930,645		
Average invested capital, including the effect of capitalized operating leases	\$2,194,890	\$2,012,431		
ROIC	16.2	%	13.6	%
ROIC, including the effect of capitalized operating leases	11.1	%	9.5	%

- (1) Net income amounts represent total net income for past four trailing quarters.
- (2) \$18.7 million income tax benefit related to the Tax Act enacted in December 2017 and \$2.6 million income tax benefit related to tax calculation method changes recognized in the third quarter of 2018, see Note 6, "Income Taxes."
- (3) Net of tax amounts are calculated using the effective tax rate for the periods presented.
- (4) Interest on capitalized leases is calculated as the trailing four quarters' rent expense multiplied by eight and by a seven percent interest rate factor.

Liquidity and Capital Resources

The following table sets forth the major sources and uses of cash for each of the periods set forth below, as well as our cash, cash equivalents and restricted cash at the end of each period (in thousands):

	Thirty-nine weeks ended	
	September 30, 2018	October 1, 2017
Cash, cash equivalents and restricted cash at end of period	\$17,831	\$18,892
Cash flows from operating activities	\$235,466	\$258,969
Cash flows used in investing activities	\$(148,432)	\$(158,429)
Cash flows used in financing activities	\$(88,682)	\$(94,113)

We have generally financed our operations principally through cash generated from operations and borrowings under our credit facilities. Our primary uses of cash are for purchases of inventory, operating expenses, capital expenditures primarily for opening new stores, remodels and maintenance, repurchases of our common stock and debt service. We believe that our existing cash, cash equivalents and restricted cash, and cash anticipated to be generated from operations will be sufficient to meet our anticipated cash needs for at least the next 12 months, and we may continue to use borrowings under our Amended and Restated Credit Agreement as discussed in Note 4, "Long-Term Debt" to fund our share repurchase programs. Our future capital requirements will depend on many factors, including new store openings, remodel and maintenance capital expenditures at existing stores, store initiatives and other corporate capital expenditures and activities. Our cash, cash equivalents and restricted cash position benefits from the fact that we generally collect cash from sales to customers the same day or, in the case of credit or debit card transactions, within days from the related sale.

Operating Activities

Cash flows from operating activities decreased \$23.5 million to \$235.5 million for the thirty-nine weeks ended September 30, 2018 compared to \$259.0 million for the thirty-nine weeks ended October 1, 2017. The decrease in cash flows from operating activities is primarily a result of changes in working capital, partially offset higher noncash depreciation and amortization.

Cash flows provided by/(used in) operating activities from changes in working capital was (\$46.5) million in the thirty-nine weeks ended September 30, 2018, compared to \$24.5 million in the thirty-nine weeks ended October 1, 2017.

Investing Activities

Cash flows used in investing activities consist primarily of capital expenditures in new stores, including leasehold improvements and store equipment, capital expenditures to maintain the appearance of our stores, sales enhancing initiatives and other corporate investments. Cash flows used in investing activities were \$148.4 million, and \$158.4 million, for the thirty-nine weeks ended September 30, 2018 and October 1, 2017, respectively.

We expect capital expenditures to be in the range of \$160 - \$165 million in fiscal 2018, including expenditures incurred to date, net of estimated landlord tenant improvement allowances, primarily to fund investments in new

stores, remodels, maintenance capital expenditures and corporate capital expenditures. We expect to fund our capital expenditures with cash on hand, cash generated from operating activities and, if required, borrowings under our Amended and Restated Credit Agreement.

Financing Activities

Cash flows used in financing activities were \$88.7 million for the thirty-nine weeks ended September 30, 2018 compared to \$94.1 million for the thirty-nine weeks ended October 1, 2017. During the thirty-nine weeks ended September 30, 2018, cash flows used in financing activities primarily consisted of \$193.3 million for stock repurchases, partially offset by \$87.0 million of net borrowings on our credit facilities, and \$21.1 million in proceeds from the exercise of stock options.

During the thirty-nine weeks ended October 1, 2017, cash flows used in financing activities primarily consisted of \$192.0 million for stock repurchases, partially offset by \$94.0 million of net borrowings on the Former Credit Facility, and \$6.6 million in proceeds from the exercise of stock options.

Long-Term Debt and Credit Facilities

Long-term debt increased \$87.0 million to \$435.0 million as of September 30, 2018, compared to December 31, 2017. The increase is due to net borrowings under our credit facilities primarily used for our share repurchase programs. See Note 4, “Long-Term Debt” of our unaudited consolidated financial statements for a description of our Amended and Restated Credit Agreement and our Former Credit Facility (each as defined therein).

Share Repurchase Program

Our board of directors from time to time authorizes share repurchase programs for our common stock. The following table outlines the share repurchase programs authorized by our board, and the related repurchase activity and available authorization as of September 30, 2018.

		Amount	Cost of	Authorization
Effective date	Expiration date	authorized	repurchases	available
November 4, 2015	November 4, 2017	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	\$ 250,000	\$ 250,000	\$ —
February 20, 2017	December 31, 2018	\$ 250,000	\$ 250,000	\$ —
February 20, 2018	December 31, 2019	\$ 350,000	\$ 66,707	\$ 283,293

The shares under our repurchase programs may be purchased on a discretionary basis from time to time prior to the applicable expiration date, subject to general business and market conditions and other investment opportunities, through open market purchases, privately negotiated transactions, or other means, including through Rule 10b5-1 trading plans. Our board’s authorization of the share repurchase programs does not obligate our Company to acquire any particular amount of common stock, and the repurchase programs may be commenced, suspended, or discontinued at any time. We have used borrowings under our credit facilities to assist with the repurchase programs (see Note 4, “Long-Term Debt” of our unaudited consolidated financial statements).

Share repurchase activity under our repurchase programs for the periods indicated was as follows (total cost in thousands):

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	September 30,	October 1,	September 30,	October 1,
	2018	2017	2018	2017
Number of common shares acquired	719,004	3,249,204	8,411,575	9,136,468
Average price per common share acquired	\$21.29	\$22.16	\$22.98	\$21.01
Total cost of common shares acquired	\$15,307	\$72,000	\$193,307	\$192,000

Shares purchased under our repurchase programs were subsequently retired.

Contractual Obligations

We are committed under certain capital leases for the rental of certain land and buildings and certain operating leases for rental of facilities and equipment. These leases expire or become subject to renewal clauses at various dates through 2034.

The following table summarizes our contractual obligations as of September 30, 2018, and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

	Payments Due by Period				
	Total	Less Than	1-3 Years	4-5 Years	More Than
	(in thousands)	1 Year			5 Years
\$700.0 million Credit Agreement (1)	\$435,000	—	—	\$435,000	—
Interest payments on \$700.0 million Credit Agreement (2)	69,831	16,063	33,305	20,463	—
Capital and financing lease obligations(3)	123,421	16,444	31,692	26,810	48,475
Operating lease obligations(3)	1,690,376	155,489	334,592	310,553	889,742
Totals	\$2,318,628	\$187,996	\$399,589	\$792,826	\$938,217

- (1) The Amended and Restated Credit Agreement is scheduled to mature and the commitments thereunder will terminate on March 27, 2023, subject to extensions as set forth therein. These borrowings are reflected in the “4-5 Years” column and discussed in the financing activities section above. See Note 4, “Long-Term Debt” to our unaudited consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q.
- (2) Represents estimated interest payments through the March 27, 2023 maturity date of our Amended and Restated Credit Agreement based on the outstanding amounts as of September 30, 2018 and based on LIBOR rates in effect at the time of this report, net of interest rate swaps.
- (3) Represents estimated payments for capital and financing and operating lease obligations as of September 30, 2018. Capital and financing lease obligations and operating lease obligations are presented gross without offset for subtenant rentals. We have subtenant agreements under which we will receive \$1.5 million for the period of less than one year, \$2.7 million for years one to three, \$2.1 million for years four to five, and \$2.2 million for the period beyond five years.

We have other contractual commitments which were presented under Contractual Obligations in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017, and for which there have not been material changes since that filing through September 30, 2018.

Off-Balance Sheet Arrangements

We do not engage in any off-balance sheet financing activities, nor do we have any interest in entities referred to as variable interest entities.

Impact of Inflation and Deflation

Inflation and deflation in the prices of food and other products we sell may periodically affect our sales, gross profit and gross margin. The short-term impact of inflation and deflation is largely dependent on whether or not the effects are passed through to our customers, which is subject to competitive market conditions.

Food inflation and deflation is affected by a variety of factors, including among other things weather conditions, product supply and geopolitical conditions (including tariffs), and our determination of whether to pass on the effects

of inflation or deflation to our customers is made in conjunction with our overall pricing and marketing strategies, as well as our competitors' responses. Although we may experience periodic effects on sales, gross profit, gross margins and cash flows as a result of changing prices, we do not expect the effect of inflation or deflation to have a material impact on our ability to execute our long-term business strategy.

Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales and expenses, cash flow and related disclosure of contingent assets and liabilities. Our estimates include, but are not limited to, those related to inventory, lease assumptions, self-insurance reserves, sublease assumptions for closed stores, goodwill and intangible assets, impairment of long-lived assets, fair values of equity-based awards and derivatives, and income taxes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates. To the extent that there are material differences between these estimates and our actual results, our future financial statements will be affected.

There have been no substantial changes to these estimates or the policies related to them during the thirty-nine weeks ended September 30, 2018. For a full discussion of these estimates and policies, see “Critical Accounting Estimates” in Item 7 of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Recently Issued Accounting Pronouncements

See Note 2, “Summary of Significant Accounting Policies” to our accompanying unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q.

We have determined that all other recently issued accounting standards will not have a material impact on our financial statements, or do not apply to our operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As described in Note 4, “Long-Term Debt” to our unaudited consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q, we have an Amended and Restated Credit Agreement that bears interest at a rate based in part on LIBOR. Accordingly, we are exposed to fluctuations in interest rates. Based on the \$435.0 million principal outstanding under our Amended and Restated Credit Agreement as of September 30, 2018, each hundred basis point change in LIBOR would result in a change in interest expense by \$4.4 million annually. We have entered into an interest rate swap agreement in December 2017 to manage our cash flow associated with variable interest rates. The notional dollar amount of the five outstanding swaps at December 31, 2017 and September 30, 2018 was \$250.0 million under which we pay a fixed rate and received a variable rate of interest (cash flow swap). Taking into account the interest rate swaps, based on the \$435.0 million principal outstanding under our Amended and Restated Credit Agreement as of September 30, 2018, each hundred basis point change in LIBOR would result in a change in interest expense by \$1.9 million annually.

This sensitivity analysis assumes our mix of financial instruments and all other variables will remain constant in future periods. These assumptions are made in order to facilitate the analysis and are not necessarily indicative of our future intentions.

We do not enter into derivative financial instruments for trading purposes (see Note 11, “Derivative Financial Instruments” of our unaudited consolidated financial statements).

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

We maintain a system of disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) designed to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time period specified in the rules and forms of the Securities and Exchange Commission, and is accumulated and communicated to our management, including our Chief Executive Officer (our principal executive officer) and our Chief Financial Officer (our principal financial officer), as appropriate, to allow timely decisions regarding required disclosure.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures under the Exchange Act as of September 30, 2018, the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

During the quarterly period ended September 30, 2018, there were no changes in our internal controls over financial reporting that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

From time to time we are a party to legal proceedings, including matters involving personnel and employment issues, product liability, personal injury, intellectual property and other proceedings arising in the ordinary course of business, which have not resulted in any material losses to date. Although management does not expect that the outcome in these proceedings will have a material adverse effect on our financial condition or results of operations, litigation is inherently unpredictable. Therefore, we could incur judgments or enter into settlements of claims that could materially impact our results.

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against our company and certain of our directors and officers on behalf of a purported class of purchasers of shares of our common stock in our underwritten secondary public offering which closed on March 10, 2015 (the “March 2015 Offering”). The complaint purports to state claims under Sections 11, 12 and 15 of the Securities Act of 1933, as amended, based on an alleged failure by our company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint seeks damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys’ fees. After removal to federal court, the plaintiff sought remand, which the court granted in March 2017. On May 25, 2017, our company filed a Motion to Dismiss in the Superior Court for the State of Arizona, which the court granted in part and denied in part by order entered August 30, 2017. On August 15, 2018, we reached an agreement in principle to settle these claims. The parties’ settlement agreement will be presented to the court for approval. If approved by the court, the settlement will be funded from our directors and officers liability insurance policy and will not have a material impact on our consolidated financial statements.

“Phishing” Scam Actions

In April 2016, four complaints were filed, two in the federal courts of California, one in the Superior Court of California and one in the federal court in the District of Colorado, each on behalf of a purported class of our current and former team members whose personally identifiable information (referred to as “PII”) was inadvertently disclosed to an unauthorized third party that perpetrated an email “phishing” scam against one of our team members. The complaints allege we failed to properly safeguard the PII in accordance with applicable law. The complaints seek damages on behalf of the purported class in unspecified amounts, attorneys’ fees and litigation expenses. In June 2016, a motion was filed before the Judicial Panel on Multidistrict Litigation (referred to as “JPML”) to transfer and consolidate all four of the cases to the federal court in the District of Arizona. The JPML granted the motion on October 6, 2016. On May 24, 2017, the JPML granted our motion to stay proceedings in the case pending a U.S. Supreme Court ruling on the question of whether arbitration agreements like those signed by each of the named plaintiffs are enforceable. On May 21, 2018, the Supreme Court issued its opinion in *Epic Systems Corp. v. Lewis* and upheld enforceability of arbitration agreements containing class action waivers, like the ones the named plaintiffs signed in this matter. Subsequent to the stay, it remains to be seen what strategy plaintiffs will pursue following *Epic Systems*. We intend to defend these cases vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the cases.

Proposition 65 Coffee Action

On April 13, 2010, an organization named Council for Education and Research on Toxics (“CERT”) filed a lawsuit in the Superior Court of the State of California, County of Los Angeles, against nearly 80 defendants who manufacture, package, distribute or sell brewed coffee, including Sprouts. CERT alleges that the defendants failed to provide

warnings for their coffee products of exposure to the chemical acrylamide as required under California Health and Safety Code section 25249.5, the California Safe Drinking Water and Toxic Enforcement Act of 1986, better known as Proposition 65. CERT seeks equitable relief, including providing warnings to consumers of coffee products, as well as civil penalties.

Our company, as part of a joint defense group, asserted multiple defenses against the lawsuit. On May 7, 2018, the trial court issued a ruling adverse to defendants on these defenses to liability. On June 15, 2018, before the court tried damages, remedies and attorneys' fees, California's Office of Environmental Health Hazard Assessment ("OEHHA") published a proposal to amend Proposition 65's implementing regulations by adding a stand-alone sentence that reads as follows: "Exposures to listed chemicals in coffee created by and inherent in the processes of roasting coffee beans or brewing coffee do not pose a significant risk of cancer." OEHHA accepted public comments on the proposed regulation until August 30, 2018, and expects that the proposed regulation, if finalized, could be effective as early as January 2019. The joint defense group sought a stay of the lawsuit pending resolution of OEHHA's rulemaking, and a temporary stay order was granted by the Court of Appeal of the State of California on October 12, 2018, until further order.

At this stage of the proceedings, prior to a trial on the remedies issues, Sprouts is unable to predict or reasonably estimate the potential loss or effect on our company or our operations. Accordingly, no loss contingency was recorded for this matter. If the proposed regulation is not adopted, or the court determines that it does not apply to this case, the trial court has discretion to impose zero penalties against our company or to impose significant statutory penalties. Significant labeling or warning requirements that could potentially be imposed by the trial court may increase our costs and adversely affect sales of our coffee products. Furthermore, a future appellate court decision could reverse the trial court rulings. The outcome and the financial impact of settlement or the trial or appellate court rulings of the case to our company, if any, cannot be predicted.

Item 1A. Risk Factors.

Certain factors may have a material adverse effect on our business, financial condition and results of operations. You should carefully consider the risks and uncertainties referenced below, together with all of the other information in this Quarterly Report on Form 10-Q, including our consolidated financial statements and related notes. Any of those risks could materially and adversely affect our business, operating results, financial condition, or prospects and cause the value of our common stock to decline, which could cause you to lose all or part of your investment.

There have been no material changes to the Risk Factors described under "Part I – Item 1A. Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

Issuer Purchases of Equity Securities

The following table provides information about our share repurchase activity during the thirty-nine weeks ended September 30, 2018.

Period (1)	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs	Approximate dollar value of shares that may yet be purchased under the plans or
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				programs
July 2, 2018 - July 29, 2018	215,795	\$ 21.25	215,795	\$ 294,023,000
July 30, 2018 - August 26, 2018	503,209	\$ 21.31	503,209	\$ 283,293,000
August 27, 2018 - September 30, 2018	—	—	—	\$ 283,293,000

(1) Periodic information is presented by reference to our fiscal periods during the third quarter of fiscal year 2018.

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Item 6. Exhibits.

Exhibit

Number Description

10.1† Distribution Agreement, dated as of July 18, 2018, by and between SFM, LLC dba Sprouts Farmers Market and KeHE Distributors, LLC

31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

101.LAB XBRL Taxonomy Extension Label Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

† Portions of this exhibit (indicated by asterisks) have been omitted pursuant to a confidential treatment request submitted separately to the SEC pursuant to Rule 406 under the Securities Act.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SPROUTS FARMERS MARKET, INC.

Date: November 1, 2018 By: /s/ Bradley S. Lukow
Name: Bradley S. Lukow
Title: Chief Financial Officer
(Principal Financial Officer)