Sprouts Farmers Market, Inc.
Form 10-Q
August 02, 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 July 1, 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 incorporation or organization) | (I.R.S. Employer 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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post 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 (Do not check if a smaller reporting company) | 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 August 1, 2018, the registrant had 127,086,822 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 JULY 1, 2018

TABLE OF CONTENTS

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,” “poten “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)

| | July 1, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $23,174 | $19,479 |
| Accounts receivable, net | 27,580 | 25,893 |
| Inventories | 250,564 | 229,542 |
| Prepaid expenses and other current assets | 28,696 | 24,593 |
| Total current assets | 330,014 | 299,507 |
| Property and equipment, net of accumulated depreciation | 776,323 | 713,031 |
| Intangible assets, net of accumulated amortization | 195,504 | 196,205 |
| Goodwill | 368,078 | 368,078 |
| Other assets | 13,850 | 4,782 |
| Total assets | $1,683,769 | $1,581,603 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable and other accrued liabilities | $265,578 | $244,853 |
| Accrued salaries and benefits | 38,410 | 45,623 |
| Current portion of capital and financing lease obligations | 14,362 | 9,238 |
| Total current liabilities | 318,350 | 299,714 |
| Long-term capital and financing lease obligations | 121,647 | 125,489 |
| Long-term debt | 458,000 | 348,000 |
| Other long-term liabilities | 139,984 | 130,640 |
| Deferred income tax liability | 44,616 | 27,066 |
| Total liabilities | 1,082,597 | 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, 127,570,117 shares issued and outstanding, July 1, 2018; 132,823,981 shares issued and outstanding, December 31, 2017 | 126 | 132 |

| | | |
|---|---|---|
| Additional paid-in capital | 636,445 | 620,788 |
| Accumulated other comprehensive income (loss) | 3,702 | (784 ) |
| (Accumulated deficit) retained earnings | (39,101 ) | 30,558 |
| Total stockholders' equity | 601,172 | 650,694 |
| Total liabilities and stockholders' equity | $1,683,769 | $1,581,603 |

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

1

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(UNAUDITED)

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

| | Thirteen Weeks Ended | | Twenty-six Weeks Ended | |
|---|---|---|---|---|
| | July 1, 2018 | July 2, 2017 | July 1, 2018 | July 2, 2017 |
| Net sales | $1,321,693 | $1,183,975 | $2,608,889 | $2,314,620 |
| Cost of sales, buying and occupancy | 941,281 | 841,989 | 1,841,425 | 1,635,348 |
| Gross profit | 380,412 | 341,986 | 767,464 | 679,272 |
| Direct store expenses | 272,973 | 236,087 | 535,568 | 465,145 |
| Selling, general and administrative expenses | 43,437 | 38,189 | 84,884 | 70,357 |
| Store pre-opening costs | 2,275 | 4,141 | 5,595 | 7,599 |
| Store closure and other costs | 26 | 98 | 36 | 189 |
| Income from operations | 61,701 | 63,471 | 141,381 | 135,982 |
| Interest expense | (6,544) | (5,100) | (12,609) | (9,838) |
| Other income | 117 | 131 | 325 | 226 |
| Income before income taxes | 55,274 | 58,502 | 129,097 | 126,370 |
| Income tax provision | (13,565) | (17,534) | (20,764) | (39,115) |
| Net income | $41,709 | $40,968 | $108,333 | $87,255 |
| Net income per share: | | | | |
| Basic | $0.32 | $0.30 | $0.83 | $0.64 |
| Diluted | $0.32 | $0.29 | $0.82 | $0.62 |
| Weighted average shares outstanding: | | | | |
| Basic | 129,423 | 136,796 | 130,924 | 136,933 |
| Diluted | 130,012 | 139,493 | 131,949 | 139,847 |

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 | | Twenty-six Weeks Ended | |
|---|---|---|---|---|
| | July 1, 2018 | July 2, 2017 | July 1, 2018 | July 2, 2017 |
| Net income | $41,709 | $40,968 | $108,333 | $87,255 |
| Other comprehensive income, net of tax | | | | |
| Unrealized gain on cash flow hedging activities, net of income tax of $404, $0, $1,552 and $0 | 1,166 | — | 4,486 | — |
| Total other comprehensive income | $1,166 | $— | $4,486 | $— |
| Comprehensive income | $42,875 | $40,968 | $112,819 | $87,255 |

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)

| | Shares | Common Stock | Additional Paid In Capital | (Accumulated deficit) Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Stockholders' 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 | | | | 108,333 | | 108,333 |
| Other comprehensive income (loss) | | | | | 4,486 | 4,486 |
| Issuance of shares under stock plans | 2,398,730 | 2 | 7,027 | | | 7,029 |
| Repurchase and retirement of common stock | (7,692,571) | (8) | | (177,992) | | (178,000) |
| Equity-based compensation | | | 8,630 | | | 8,630 |
| Balances at July 1, 2018 | 127,156,251 | $ 126 | $ 636,445 | $ (39,101) | $ 3,702 | 601,172 |

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)

| | Twenty-six Weeks Ended | |
|---|---|---|
| | July 1, 2018 | July 2, 2017 |
| Cash flows from operating activities | | |
| Net income | $108,333 | $87,255 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization expense | 53,829 | 46,142 |
| Accretion of asset retirement obligation and closed store reserve | 147 | 94 |
| Amortization of financing fees and debt issuance costs | 517 | 231 |
| Loss on disposal of property and equipment | 236 | 356 |
| Equity-based compensation | 8,630 | 6,239 |
| Deferred income taxes | 17,550 | 18,039 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (2,954) | 4,106 |
| Inventories | (21,022) | (13,940) |
| Prepaid expenses and other current assets | (1,312) | (1,549) |
| Other assets | (6,745) | (2,450) |
| Accounts payable and other accrued liabilities | 10,379 | 24,996 |
| Accrued salaries and benefits | (7,154) | 2,051 |
| Other long-term liabilities | 10,674 | 8,313 |
| Cash flows from operating activities | 171,108 | 179,883 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (103,936) | (117,753) |
| Proceeds from sale of property and equipment | 1 | 30 |
| Cash flows used in investing activities | (103,935) | (117,723) |
| Cash flows from financing activities | | |
| Proceeds from revolving credit facilities | 140,000 | 85,000 |
| Payments on revolving credit facilities | (30,000) | (30,000) |
| Payments on capital and financing lease obligations | (2,135) | (2,068) |
| Payments of deferred financing costs | (2,131) | — |
| Cash from landlords related to capital and financing lease obligations | 2,113 | 1,325 |
| Repurchase of common stock | (178,000) | (120,000) |
| Proceeds from exercise of stock options | 6,734 | 5,932 |
| Other | (59) | — |
| Cash flows used in financing activities | (63,478) | (59,811) |
| Increase in cash and cash equivalents | 3,695 | 2,349 |
| Cash and cash equivalents at beginning of the period | 19,479 | 12,465 |
| Cash and cash equivalents at the end of the period | $23,174 | $14,814 |

| | | |
|---|---|---|
| Supplemental disclosure of cash flow information | | |
| Cash paid for interest | $12,292 | $9,438 |
| Cash paid for income taxes | 12,291 | 19,595 |
| | | |
| Supplemental disclosure of non-cash investing and financing activities | | |
| Property and equipment in accounts payable | $27,959 | $16,358 |
| Property acquired through capital and financing lease obligations | 7,452 | 9,774 |

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

5

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

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 July 1, 2018. The Company had a net gift card liability balance of $7.6 million as of July 1, 2018 and $13.1 million as of December 31, 2017. During the twenty-six weeks ended July 1, 2018, the Company recognized $12.0 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.

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 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 in fiscal year 2018, and the adoption did not have an impact on the Company's consolidated financial statements or disclosures.

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 finance or operating lease. The new guidance also requires certain additional quantitative and qualitative disclosures. This guidance will be effective for the Company for its fiscal year 2019, with early adoption permitted, and the Company is currently evaluating the potential impact of this guidance. The adoption of this ASU is expected to result in a material increase to the Company's consolidated balance sheets for right-of-use assets and lease liabilities.

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.

No other new accounting pronouncements issued or effective during the twenty-six weeks ended July 1, 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.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 July 1, 2018 and December 31, 2017:

| July 1, 2018 | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Long-term debt | $ — | $458,000 | $ — | $458,000 |
| Total liabilities | $ — | $458,000 | $ — | $458,000 |
| | | | | |
| Interest rate swap asset | $ — | $4,990 | $ — | $4,990 |
| Total assets | $ — | $4,990 | $ — | $4,990 |

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

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 and cash equivalents, 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 July 1, 2018 and December 31, 2017.

4. Long-Term Debt

A summary of long-term debt is as follows:

| | | | As of | |
|---|---|---|---|---|
| Facility | Maturity | Interest Rate | July 1, 2018 | December 31, 2017 |

| | | | | |
|---|---|---|---|---|
| Senior secured debt | | | | |
| $700.0 million Credit Agreement | March 27, 2023 | Variable | $458,000 | $— |
| Former Credit Facility | April 17, 2020 | Variable | — | 348,000 |
| Total debt | | | 458,000 | 348,000 |
| Long-term debt | | | $458,000 | $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.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 July 1, 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 July 1, 2018, primarily to support the Company’s insurance programs.

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 55% of outstanding debt under the Amended and Restated Credit Agreement is fixed, due to certain floating to fixed swaps implemented in December 2017 (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 twenty-six weeks ended July 1, 2018, the Company borrowed an additional $140.0 million primarily for share repurchases and made a total of $30.0 million of principal payments; resulting in total outstanding debt under the Amended and Restated Credit Agreement of $458.0 million as of July 1, 2018.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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;
- 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 July 1, 2018.

The Company was in compliance with all applicable covenants under the Amended and Restated Credit Agreement as of July 1, 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.

11

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

## 5. Closed Store Reserves

The following is a summary of closed store reserve activity during the twenty-six weeks ended July 1, 2018 and fiscal year 2017:

| | Twenty-six Weeks Ended July 1, 2018 | Fiscal Year Ended December 31, 2017 |
|---|---|---|
| Beginning balance | $ 811 | $ 1,083 |
| Additions | — | — |
| Usage | (213) | (492) |
| Adjustments | 73 | 220 |
| Ending balance | $ 671 | $ 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.

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. In 2017, the Company had substantially completed the measurement and made a provisional and reasonable estimate of the effects of the Tax Act on its existing deferred tax balances. The final impact of the Tax Act may differ due to changes in interpretations and assumptions the Company has made and guidance that may be issued. In accordance with SAB 118, future adjustments to the provisional numbers will be recorded as discrete adjustments to income tax expense in the period in which those adjustments become estimable and finalized. As of July 1, 2018, the Company has not made any changes to the provisional and estimated amounts.

The Company’s effective tax rate decreased to 24.5% for the thirteen weeks ended July 1, 2018 from 30.0% for the thirteen weeks ended July 2, 2017 primarily due to the enactment of the Tax Act as disclosed above offset by a lower amount of excess tax benefits related to the exercise of stock options recognized in the income tax provision.

The Company’s effective tax rate decreased to 16.1% for the twenty-six weeks ended July 1, 2018 from 31.0% for the twenty-six weeks ended July 2, 2017 primarily due to the enactment of the Tax Act as disclosed above, and the recognition of excess tax benefits related to the exercise of stock options in the income tax provision.

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 \$0.2 million and \$4.4 million for the thirteen weeks ended July 1, 2018 and July 2, 2017, respectively. The income tax benefits resulting from excess tax benefits of share-based payment awards were \$11.4 million and \$8.2 million for the twenty-six weeks ended July 1, 2018 and July 2, 2017, respectively.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

## 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 July 1, 2018 and July 2, 2017, purchases from this supplier were $0.3 million and $2.7 million, respectively. During the twenty-six weeks ended July 1, 2018 and July 2, 2017, purchases from this supplier were $2.6 million and $5.4 million, respectively. As of July 1, 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 July 1, 2018 and July 2, 2017, purchases from this supplier and its predecessors were $1.4 million and $2.1 million, respectively. During the twenty-six weeks ended July 1, 2018 and July 2, 2017, purchases from this supplier and its predecessors were $2.6 million and $3.7 million, respectively. As of July 1, 2018 and December 31, 2017, the Company had recorded accounts payable due to the supplier of $0.1 million and $0.1 million, respectively.

## 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. The parties are engaged in discovery at this time. The Company will continue to defend this case vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the case.

## 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 July 1, 2018.

| Effective date | Expiration date | Amount authorized | Cost of repurchases | Authorization 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 | $ 51,400 | $ 298,600 |

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 | | Twenty-six Weeks Ended | |
|---|---|---|---|---|
| | July 1, 2018 | July 2, 2017 | July 1, 2018 | July 2, 2017 |
| Number of common shares acquired | 4,363,162 | 1,787,323 | 7,692,571 | 5,887,264 |
| Average price per common share acquired | $21.77 | $22.38 | $23.14 | $20.38 |
| Total cost of common shares acquired | $95,000 | $40,000 | $178,000 | $120,000 |

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 | | Twenty-six Weeks Ended | |
|---|---|---|---|---|
| | July 1, | July 2, | July 1, | July 2, |

| | 2018 | 2017 | 2018 | 2017 |
|---|---|---|---|---|
| Basic net income per share: | | | | |
| Net income | $41,709 | $40,968 | $108,333 | $87,255 |
| Weighted average shares outstanding | 129,423 | 136,796 | 130,924 | 136,933 |
| Basic net income per share | $0.32 | $0.30 | $0.83 | $0.64 |
| Diluted net income per share: | | | | |
| Net income | $41,709 | $40,968 | $108,333 | $87,255 |
| Weighted average shares outstanding - basic | 129,423 | 136,796 | 130,924 | 136,933 |
| Dilutive effect of equity-based awards: | | | | |
| Assumed exercise of options to purchase shares | 314 | 2,428 | 561 | 2,693 |
| RSUs | 68 | 102 | 179 | 103 |
| RSAs | 73 | 112 | 145 | 75 |
| PSAs | 134 | 55 | 140 | 43 |
| Weighted average shares and equivalent shares outstanding | 130,012 | 139,493 | 131,949 | 139,847 |
| Diluted net income per share | $0.32 | $0.29 | $0.82 | $0.62 |

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

For the thirteen weeks ended July 1, 2018, the computation of diluted net income per share does not include 1.1 million options and 0.4 million RSUs as those awards would have been antidilutive. For the thirteen weeks ended July 2, 2017, the computation of diluted net income per share does not include 1.6 million options, 0.1 million RSUs, and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

For the twenty-six weeks ended July 1, 2018, the computation of diluted net income per share does not include 1.1 million options and 0.1 million PSAs as those awards would have been antidilutive or were performance awards with performance conditions net yet deemed met. For the twenty-six weeks ended July 2, 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 July 1, 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.

| | As of | As of |
|---|---|---|
| | July 1, 2018 | December 31, 2017 |

| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
|---|---|---|---|---|
| Derivatives designated as hedging instruments | | | | |
| Interest rate swaps | Other Current Assets and Other Assets | $4,990 | Other Accrued Liabilities 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 | | Twenty-six Weeks Ended | |
|---|---|---|---|
| July 1, 2018 | July 2, 2017 | July 1, 2018 | July 2, |