

Section 1: 10-Q (10-Q)

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 October 1, 2017

Commission File Number: 001-36029



Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

32-0331600

(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	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>
Emerging growth company	<input type="checkbox"/>		

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 31, 2017, the registrant had 133,070,570 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 OCTOBER 1, 2017

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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,” “continue,” “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 January 1, 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
(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)**

	October 1, 2017	January 1, 2017
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 18,892	\$ 12,465
Accounts receivable, net	23,231	25,228
Inventories	222,216	204,464
Prepaid expenses and other current assets	25,594	21,869
Total current assets	289,933	264,026
Property and equipment, net of accumulated depreciation	690,763	604,660
Intangible assets, net of accumulated amortization	196,556	197,608
Goodwill	368,078	368,078
Other assets	5,886	5,521
Total assets	\$ 1,551,216	\$ 1,439,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 179,482	\$ 157,550
Accrued salaries and benefits	41,219	32,859
Other accrued liabilities	60,683	56,376
Current portion of capital and financing lease obligations	8,776	12,370
Total current liabilities	290,160	259,155
Long-term capital and financing lease obligations	126,806	117,366
Long-term debt	349,000	255,000
Other long-term liabilities	126,127	116,200
Deferred income tax liability	42,508	19,263
Total liabilities	934,601	766,984
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, 133,070,570 and 140,256,313 shares issued and outstanding, October 1, 2017 and January 1, 2017, respectively	133	140
Additional paid-in capital	614,232	597,269
Retained earnings	2,250	75,500
Total stockholders' equity	616,615	672,909
Total liabilities and stockholders' equity	\$ 1,551,216	\$ 1,439,893

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Net sales	\$ 1,206,059	\$ 1,035,801	\$ 3,520,679	\$ 3,060,685
Cost of sales, buying and occupancy	859,650	744,288	2,494,998	2,156,857
Gross profit	346,409	291,513	1,025,681	903,828
Direct store expenses	250,191	216,932	715,336	617,817
Selling, general and administrative expenses	39,955	29,664	110,312	91,482
Store pre-opening costs	2,456	3,446	10,055	11,625
Store closure and other costs	803	24	992	159
Income from operations	53,004	41,447	188,986	182,745
Interest expense	(5,609)	(3,723)	(15,447)	(10,985)
Other income	162	135	388	326
Income before income taxes	47,557	37,859	173,927	172,086
Income tax provision	(16,071)	(13,974)	(55,186)	(64,785)
Net income	<u>\$ 31,486</u>	<u>\$ 23,885</u>	<u>\$ 118,741</u>	<u>\$ 107,301</u>
Net income per share:				
Basic	\$ 0.23	\$ 0.16	\$ 0.87	\$ 0.72
Diluted	\$ 0.23	\$ 0.16	\$ 0.86	\$ 0.71
Weighted average shares outstanding:				
Basic	<u>134,320</u>	<u>147,743</u>	<u>136,063</u>	<u>149,202</u>
Diluted	<u>136,770</u>	<u>150,024</u>	<u>138,860</u>	<u>151,568</u>

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)

	<u>Shares</u>	<u>Common Stock</u>	<u>Additional Paid In Capital</u>	<u>Retained Earnings</u>	<u>Total Stockholders' Equity</u>
Balances at January 3, 2016	152,577,884	\$ 153	\$ 577,393	\$ 245,446	\$ 822,992
Net income	—	—	—	124,306	124,306
Issuance of shares under stock plans	666,841	—	2,740	—	2,740
Repurchase and retirement of common stock	(13,242,483)	(13)	—	(294,252)	(294,265)
Excess tax benefit for exercise of options	—	—	3,737	—	3,737
Equity-based compensation	—	—	13,399	—	13,399
Balances at January 1, 2017	140,002,242	\$ 140	\$ 597,269	\$ 75,500	\$ 672,909
Net income	—	—	—	118,741	118,741
Issuance of shares under stock plans	1,800,157	2	6,638	—	6,640
Repurchase and retirement of common stock	(9,136,468)	(9)	—	(191,991)	(192,000)
Equity-based compensation	—	—	10,325	—	10,325
Balances at October 1, 2017	<u>132,665,931</u>	<u>\$ 133</u>	<u>\$ 614,232</u>	<u>\$ 2,250</u>	<u>\$ 616,615</u>

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	
	October 1, 2017	October 2, 2016
Cash flows from operating activities		
Net income	\$ 118,741	\$ 107,301
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	70,875	59,997
Accretion of asset retirement obligation and closed store reserve	168	237
Amortization of financing fees and debt issuance costs	347	347
Loss on disposal of property and equipment	820	226
Equity-based compensation	10,325	10,322
Deferred income taxes	23,245	20,119
Changes in operating assets and liabilities:		
Accounts receivable	1,660	(1,336)
Inventories	(17,752)	(29,784)
Prepaid expenses and other current assets	(3,734)	(1,212)
Other assets	(702)	(1,480)
Accounts payable	31,669	24,050
Accrued salaries and benefits	8,360	(4,959)
Other accrued liabilities and income taxes payable	4,288	(2,762)
Other long-term liabilities	10,659	14,971
Cash flows from operating activities	<u>258,969</u>	<u>196,037</u>
Cash flows used in investing activities		
Purchases of property and equipment	(158,459)	(142,571)
Proceeds from sale of property and equipment	30	662
Purchase of leasehold interests	—	(491)
Cash flows used in investing activities	<u>(158,429)</u>	<u>(142,400)</u>
Cash flows used in financing activities		
Proceeds from revolving credit facility	134,000	45,000
Payments on revolving credit facility	(40,000)	—
Payments on capital and financing lease obligations	(3,053)	(3,144)
Cash from landlords related to financing lease obligations	300	—
Repurchase of common stock	(192,000)	(187,836)
Proceeds from exercise of stock options	6,640	2,616
Excess tax benefit for exercise of stock options	—	3,948
Cash flows used in financing activities	<u>(94,113)</u>	<u>(139,416)</u>
Increase / (Decrease) in cash and cash equivalents	6,427	(85,779)
Cash and cash equivalents at beginning of the period	12,465	136,069
Cash and cash equivalents at the end of the period	<u>\$ 18,892</u>	<u>\$ 50,290</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 15,052	\$ 10,942
Cash paid for income taxes	25,710	38,142
Supplemental disclosure of non-cash investing and financing activities		
Property and equipment in accounts payable	\$ 13,476	\$ 19,919
Property acquired through capital and financing lease obligations	5,512	8,324

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 January 1, 2017 ("fiscal year 2016") included in the Company's Annual Report on Form 10-K, filed on February 23, 2017.

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 31, 2017 ("fiscal year 2017") is a 52-week year, and fiscal year 2016 was a 52-week year. 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.

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

All dollar amounts are in thousands, unless otherwise noted.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

2. Recently Issued Accounting Pronouncements

Recently Adopted Accounting Pronouncements

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory." ASU No. 2015-11 changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. Net realizable value is defined as the estimated selling prices in the ordinary course of business; less reasonably predictable costs of completion, disposal and transportation. This guidance is effective for the Company for its fiscal year 2017. Adoption of the guidance took place prospectively during 2017, and the adoption did not have a material effect on the Company's consolidated financial statements or disclosures.

In March 2016, the FASB issued ASU No. 2016-09, "Compensation – Stock Compensation (Topic 718)." This update involves several aspects of the accounting for share-based transactions, including the income tax consequences, classification of awards as either equity or liabilities, how to account for forfeitures, and classification on the statement of cash flows. The amendments in this update are effective for the Company for its fiscal year 2017. As a result of the adoption, the Company recognized excess tax benefits related to the exercise of options in its income tax provision during the thirty-nine weeks ended October 1, 2017 (see Note 6). Prior to the adoption, these items were recorded in Additional Paid-in Capital. The Company has elected to prospectively apply the amendments related to classifying cash flows related to excess tax benefits as an operating activity. During 2017, excess tax benefits were classified as an operating activity on the consolidated statement of cash flows, along with other income tax cash flows. The Company has made a policy election to account for forfeitures as they occur. This election was adopted using a modified retrospective approach resulting in no cumulative effect on retained earnings at the beginning of the period. Prior to the adoption, forfeitures were accounted for using an estimated forfeiture rate.

Recently Issued Accounting Pronouncements Not Yet Adopted

In May 2014, the FASB issued 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. This guidance will be effective for the Company for its fiscal year 2018, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance and does not expect this ASU to materially impact the Company's consolidated financial statements.

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 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. This guidance will be effective for the Company for its fiscal year 2018, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's consolidated financial statements.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
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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. The guidance will be effective for the Company for its fiscal year 2018, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's consolidated financial statements.

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 is currently evaluating the potential impact of this guidance.

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. The guidance will be effective for the Company for its fiscal year 2018, 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 thirty-nine weeks ended October 1, 2017 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, and in the valuation of store closure and exit costs.

The determination of fair values of certain tangible and intangible assets for purposes of the Company's goodwill impairment evaluation as described above was based upon a step zero assessment. Closed facility reserves are recorded at net present value to approximate fair value which is classified as Level 3 in the hierarchy. The estimated fair value of the closed facility reserve is calculated based on the present value of the remaining lease payments and other charges using a weighted average cost of

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

capital, reduced by estimated sublease rentals. The weighted average cost of capital was estimated using information from comparable companies and management's judgment related to the risk associated with the operations of the stores.

Cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable, accrued salaries and benefits and other accrued liabilities approximate fair value because of the short maturity of those instruments. Based on open market transactions comparable to the Credit Facility (as defined in Note 4, "Long-Term Debt"), the fair value of the long-term debt approximates carrying value as of October 1, 2017 and January 1, 2017. The Company's estimates of the fair value of long-term debt were classified as Level 2 in the fair value hierarchy.

4. Long-Term Debt

A summary of long-term debt is as follows:

Facility	Maturity	Interest Rate	As of	
			October 1, 2017	January 1, 2017
Senior secured debt				
\$450.0 million Credit Facility	April 17, 2020	Variable	\$ 349,000	\$ 255,000
Total debt			<u>349,000</u>	<u>255,000</u>
Long-term debt			<u>\$ 349,000</u>	<u>\$ 255,000</u>

Senior Secured Revolving Credit Facility

On April 17, 2015, the Company's subsidiary, Sprouts Farmers Markets Holdings, LLC ("Intermediate Holdings"), as borrower, entered into a credit agreement that provides for a revolving credit facility with an initial aggregate commitment of \$450.0 million (the "Credit Facility"), which may be increased from time to time pursuant to an expansion set forth in the Credit Facility. The Credit Facility replaced the Company's existing senior secured credit facility, dated April 23, 2013.

The Company capitalized debt issuance costs of \$2.3 million related to the Credit Facility, which are being amortized on a straight-line basis to interest expense over the five-year term of the Credit Facility.

The Credit Facility also provides for a letter of credit subfacility and a \$15.0 million swingline facility. Letters of credit issued under the Credit Facility reduce the borrowing capacity of the Credit Facility. Letters of credit totaling \$24.8 million have been issued as of October 1, 2017, primarily to support the Company's insurance programs.

Guarantees

Obligations under the Credit Facility are guaranteed by the Company and all of its current and future wholly-owned material domestic subsidiaries, 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 Credit Facility bear 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 are subject to adjustment pursuant to a pricing grid based on the Company's total gross leverage ratio, as defined in the Credit Facility. Under the terms of the Credit Facility, the Company is obligated to pay a commitment fee on the available unused amount of the Credit Facility commitments equal to 0.20% per annum.

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

Payments and Borrowings

The Credit Facility is scheduled to mature, and the commitments thereunder will terminate on April 17, 2020, subject to extensions as set forth in the Credit Facility.

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

During fiscal year 2016, the Company borrowed \$105.0 million and made a total of \$10.0 million of principal payments; resulting in total outstanding debt under the Credit Facility of \$255.0 million at January 1, 2017. During the thirteen weeks ended October 1, 2017, the Company borrowed \$49.0 million and made a total of \$10.0 million of principal payments. During the thirty-nine weeks ended October 1, 2017, the Company borrowed \$134.0 million and made a total of \$40.0 million of principal payments; resulting in total outstanding debt under the Credit Facility of \$349.0 million as of October 1, 2017. The Company has used borrowings under the Credit Facility to assist with its share repurchase programs (see Note 9).

Covenants

The Credit Facility 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 Credit Facility requires that the Company and its subsidiaries maintain a maximum total net leverage ratio not to exceed 3.00 to 1.00 and minimum interest coverage ratio not to be less than 1.75 to 1.00. Each of these covenants is tested as of the last day of each fiscal quarter.

The Company was in compliance with all applicable covenants under the Credit Facility as of October 1, 2017.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

5. Closed Store and Other Costs

The following is a summary of closed store reserve activity during the thirty-nine weeks ended October 1, 2017 and fiscal year 2016:

	Thirty-nine Weeks Ended October 1, 2017	Fiscal Year Ended January 1, 2017
Beginning balance	\$ 1,083	\$ 2,017
Additions	—	—
Usage	(387)	(998)
Adjustments	205	64
Ending balance	<u>\$ 901</u>	<u>\$ 1,083</u>

The Closed Store Reserve is included in Other accrued liabilities and Other long-term liabilities in the consolidated balance sheets. Usage relates to lease payments made during the period for closed stores.

During August and September 2017, 14 of our stores in Texas, Florida and Georgia were affected by Hurricanes Harvey and Irma. While physical damage was minimal, these stores experienced, to varying degrees, loss of perishable inventory, additional expenses to clean up and power stores, and a loss of business while closed. Actual costs incurred, not including the impact of lost sales, are estimated to be \$1.0 million, with an estimated insurance recovery of \$0.3 million for these costs. We are pursuing additional recovery under our business interruption and other insurance policy provisions; however, any additional recoveries are not expected to be material.

6. Income Taxes

The Company's effective tax rate for the thirteen weeks ended October 1, 2017 and October 2, 2016 was 33.8% and 36.9%, respectively. The decrease in the effective tax rate is primarily due to tax return to provision adjustments for the 2016 income tax return.

The Company's effective tax rate for the thirty-nine weeks ended October 1, 2017 and October 2, 2016 was 31.7% and 37.7%, respectively. The decrease in the effective tax rate is primarily related to recognition of excess tax benefits related to the exercise or vesting of equity-based awards in the income tax provision. See ASU 2016-09, Compensation – "Stock Compensation (Topic 718)" under Recently Adopted Accounting Pronouncements (Note 2).

Excess tax benefits associated with share-based payment awards are recognized as income tax expense or benefit in the income statement. 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 equity-based awards were \$0.2 million for the thirteen weeks ended October 1, 2017. The income tax benefits resulting from the equity-based awards for the thirteen weeks ended October 2, 2016 were \$0.2 million and recorded in Additional Paid-in Capital.

The income tax benefits resulting from equity-based awards were \$8.4 million for the thirty-nine weeks ended October 1, 2017. The income tax benefits resulting from equity-based awards for the thirty-nine weeks ended October 2, 2016 were \$3.9 million and recorded in Additional Paid-in Capital.

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 October 1, 2017 and October 2, 2016, purchases from this supplier were \$2.7 million and \$2.1 million, respectively. During the thirty-nine weeks ended October 1, 2017 and October 2, 2016, purchases from this supplier were \$8.1 million and \$7.3 million.

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million, respectively. The Company had recorded accounts payable due to this vendor of \$0.7 million, as of both October 1, 2017 and October 2, 2016, respectively.

The Company's former Executive Chairman of the Board has been the chief executive officer, an equity investor, and lender to a technology supplier to the Company. During the thirteen weeks ended October 1, 2017 and October 2, 2016, purchases from this supplier and its predecessors were \$1.6 million and \$2.2 million, respectively. During the thirty-nine weeks ended October 1, 2017 and October 2, 2016, purchases from this supplier and its predecessors were \$5.2 million and \$6.0 million, respectively. As of October 1, 2017, and October 2, 2016, the Company had recorded accounts payable due to the supplier of \$0.2 million and \$0.5 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. 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, 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 plaintiffs sought remand, which the court granted in March 2017. The Company has appealed the order granting remand to the Ninth Circuit Court of Appeals. 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 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

On November 4, 2015, the Company's board of directors authorized a \$150 million common stock share repurchase program, which was completed during the second quarter of 2016. On September 6, 2016, the Company's board of directors authorized a \$250 million common stock share repurchase program, which was completed during the first quarter of 2017. On February 20, 2017, the Company's board of directors authorized a new \$250 million common stock share repurchase program. The following table outlines the share repurchase programs authorized by the Board, and the related repurchase activity and available authorization as of October 1, 2017 (in thousands):

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	\$ 112,000	\$ 138,000

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

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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 Credit Facility to assist with the repurchase programs authorized on September 6, 2016 and February 20, 2017 (see Note 4).

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	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Number of common shares acquired	3,249,204	3,189,818	9,136,468	8,169,510
Average price per common share acquired	\$ 22.16	\$ 19.93	\$ 21.01	\$ 22.99
Total cost of common shares acquired	\$ 72,000	\$ 63,572	\$ 192,000	\$ 187,836

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	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Basic net income per share:				
Net income	\$ 31,486	\$ 23,885	\$ 118,741	\$ 107,301
Weighted average shares outstanding	134,320	147,743	136,063	149,202
Basic net income per share	\$ 0.23	\$ 0.16	\$ 0.87	\$ 0.72
Diluted net income per share:				
Net income	\$ 31,486	\$ 23,885	\$ 118,741	\$ 107,301
Weighted average shares outstanding - basic	134,320	147,743	136,063	149,202
Dilutive effect of equity-based awards:				
Assumed exercise of options to purchase shares	2,128	2,200	2,506	2,278
RSUs	122	28	124	49
RSAs	114	13	102	9
PSAs	86	40	65	30
Weighted average shares and equivalent shares outstanding	136,770	150,024	138,860	151,568
Diluted net income per share	\$ 0.23	\$ 0.16	\$ 0.86	\$ 0.71

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 thirteen weeks ended October 2, 2016, the computation of diluted net income per share does not include 2.2 million options, 0.1 million RSUs, and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

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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. For the thirty-nine weeks ended October 2, 2016, the computation of diluted net income per share does not include 1.3 million options, 0.1 million RSUs and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

11. 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 equity-based and cash-based incentive compensation programs for its directors, officers and other team members. 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.

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 October 1, 2017, there were 3,686,043 stock awards outstanding and 5,805,674 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 October 1, 2017, there were 2,384,978 options outstanding under the 2011 Option Plan.

Awards Granted

During the thirty-nine weeks ended October 1, 2017, the Company granted the following equity-based compensation awards:

Grant Date	RSUs	PSAs	RSAs
March 2017	325,406	148,944	288,746
May 2017	21,820	—	—
August 2017	10,630	—	—
Total:	<u>357,856</u>	<u>148,944</u>	<u>288,746</u>
<i>Weighted-average grant date fair value</i>	\$ 18.66	\$ 18.11	\$ 18.11

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.

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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. During the thirty-nine weeks ended October 2, 2016, the performance conditions with respect to 2015 earnings per share were deemed to have been met, and the PSAs will vest 50 percent at each of the second and third anniversary of the grant date. During the thirty-nine weeks ended October 1, 2017, 21,050 of the 2015 PSAs were vested. No PSAs vested during the thirty-nine weeks ended October 2, 2016.

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 fair value of these PSAs is based on the closing price of the Company's common stock on the grant date. The EBIT target resets annually for each of the three years during the performance period based on a percentage increase over the previous year's actual EBIT, with each annual performance tranche independent of the previous and next tranche. Cumulative performance is based on the aggregate annual performance targets. Payout of the performance shares will either be 0% or range from 50% to 150% of the target number of shares granted. If the performance conditions are met, PSAs cliff vest on the third anniversary of the grant date. The Company's board of directors determined that the performance targets for the fiscal year 2016 tranche were not met and 30,981 performance shares were not earned.

PSAs granted in fiscal year 2017 are restricted shares that are 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. Payout of the performance shares will either be 0% or range from 10% to 150% of the target number of shares granted. If the performance conditions are met, PSAs will vest 50 percent at each of the second and third anniversary of the grant date.

RSAs

The fair value of RSAs is based on the closing price of the Company's common stock on the grant date. RSAs granted prior to January 1, 2017 will vest either ratably over a seven quarter period, beginning on December 31, 2016 or cliff vest on June 30, 2018. RSAs granted in fiscal year 2017 will vest annually over a period of three years from the grant date.

Equity Award Restructuring

In connection with the appointments of the Company's Chief Executive Officer and President & Chief Operating Officer in August 2015, the Compensation Committee of the Company's Board of Directors approved a grant of stock options to purchase 1,200,000 and 500,000 shares of the Company's common stock at an exercise price of \$20.98 per share to these officers, respectively (the "August 2015 Options") pursuant to the 2013 Incentive Plan. The August 2015 Options, taken together with other options granted under the 2013 Incentive Plan to such officers during 2015, exceeded the limit of 500,000 shares which may be granted pursuant to stock options and stock appreciation rights per calendar year to each participant under the 2013 Incentive Plan by 733,439 shares in the case of the Company's Chief Executive Officer and 33,439 shares in the case of the Company's President & Chief Operating Officer (the "Excess Options"). Accordingly, the Company has determined, and these officers have acknowledged, that the grants of the Excess Options were null and void.

In order to satisfy the original intent with respect to these individuals' compensation, on May 23, 2016, the Compensation Committee granted to the Company's Chief Executive Officer and President & Chief Operating Officer under the 2013 Incentive Plan options to purchase 386,496 and 33,439 shares of

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the Company's common stock at an exercise price of \$24.48 per share, respectively, and 215,251 and 2,601 RSAs, respectively. The Company recognized compensation expense of \$0.9 million during the thirteen week period and \$2.9 million during the thirty-nine week period ended October 1, 2017 related to the options and RSAs granted. The Company recognized compensation expense of \$1.0 million during the thirteen week period and \$1.4 million during the thirty-nine week period ended October 2, 2016 related to the options and RSAs granted.

Equity-based Compensation Expense

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Cost of sales, buying and occupancy	\$ 265	\$ 244	\$ 777	\$ 726
Direct store expenses	349	339	1,098	1,015
Selling, general and administrative expenses	3,471	3,414	8,450	8,581
Equity-based compensation expense before income taxes	4,085	3,997	10,325	10,322
Income tax benefit	(1,528)	(1,519)	(3,863)	(3,922)
Net equity-based compensation expense	<u>\$ 2,557</u>	<u>\$ 2,478</u>	<u>\$ 6,462</u>	<u>\$ 6,400</u>

The following equity-based awards were outstanding as of October 1, 2017 and January 1, 2017:

	As of	
	October 1, 2017	January 1, 2017
	(in thousands)	
Options		
Vested	4,394	5,552
Unvested	609	1,205
RSUs	453	274
PSAs	231	159
RSAs	384	187

As of October 1, 2017, total unrecognized compensation expense related to outstanding equity-based awards was as follows:

	As of October 1, 2017
Options	\$ 3,629
RSUs	6,803
PSAs	3,171
RSAs	6,106
Total unrecognized compensation expense	<u>\$ 19,709</u>

As of October 1, 2017, the total remaining weighted average recognition period related to outstanding equity-based awards was as follows:

	As of October 1, 2017
Options	1.0
RSUs	1.7
PSAs	1.7
RSAs	2.0

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During the thirty-nine weeks ended October 1, 2017 and October 2, 2016, the Company received \$6.6 million and \$2.6 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 February 23, 2017 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 offers fresh, natural and organic food that includes fresh produce, bulk foods, vitamins and supplements, packaged groceries, meat and seafood, deli, baked goods, dairy products, frozen foods, body care and natural household items catering to consumers' growing interest in health and wellness. Since our founding in 2002, we have grown rapidly, significantly increasing our sales, store count and profitability. With 282 stores in 15 states as of October 1, 2017, we are one of the largest specialty retailers of fresh, natural and organic food in the United States. As of November 1, 2017, we have grown to 285 stores in 15 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 October 1, 2017, we continued to open new stores while successfully rebranding 43 Henry's Farmers Market and 39 Sunflower Farmers Market stores added through acquisitions to the Sprouts banner (referred to as the "Transactions"). 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 32 new stores in 2017, of which all 32 have opened through November 1, 2017, and approximately 30 new stores per year for the near term.

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 October 1, 2017 and October 2, 2016

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	
	October 1, 2017	October 2, 2016
Unaudited Consolidated Statement of Operations Data:		
Net sales	\$ 1,206,059	\$ 1,035,801
Cost of sales, buying and occupancy	859,650	744,288
Gross profit	346,409	291,513
Direct store expenses	250,191	216,932
Selling, general and administrative expenses	39,955	29,664
Store pre-opening costs	2,456	3,446
Store closure and other costs	803	24
Income from operations	53,004	41,447
Interest expense	(5,609)	(3,723)
Other income	162	135
Income before income taxes	47,557	37,859
Income tax provision	(16,071)	(13,974)
Net income	\$ 31,486	\$ 23,885
Weighted average shares outstanding	134,320	147,743
Dilutive effect of equity-based awards	2,450	2,281
Weighted average shares and equivalent shares outstanding	136,770	150,024
Diluted net income per share	\$ 0.23	\$ 0.16

	Thirteen weeks ended	
	October 1, 2017	October 2, 2016
Other Operating Data:		
Comparable store sales growth	4.6%	1.3%
Stores at beginning of period	274	240
Opened	8	10
Stores at end of period	282	250

**Comparison of Thirteen Weeks Ended October 1, 2017 to Thirteen Weeks Ended
October 2, 2016**

Net sales

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net sales	\$ 1,206,059	\$ 1,035,801	\$ 170,258	16%
Comparable store sales growth	4.6%	1.3%		

Net sales during the thirteen weeks ended October 1, 2017 totaled \$1.2 billion, increasing 16% over the same period of the prior fiscal year. Sales growth was primarily driven by solid performance in new stores opened. Comparable stores contributed approximately 87% of net sales for each of the thirteen weeks ended October 1, 2017 and October 2, 2016, respectively.

Cost of sales, buying and occupancy and gross profit

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net sales	\$ 1,206,059	\$ 1,035,801	\$ 170,258	16%
Cost of sales, buying and occupancy	859,650	744,288	115,362	15%
Gross profit	346,409	291,513	54,896	19%
Gross margin	28.7%	28.1%	0.6%	

Gross profit increased during the thirteen weeks ended October 1, 2017 compared to the thirteen weeks ended October 2, 2016 by \$54.9 million, of which \$47.4 million was as a result of increased sales volume and \$7.5 million related to increased margin rate. This improvement was primarily driven by cycling a heightened promotional environment in the third quarter of 2016 in addition to leverage from increased comparable sales.

Direct store expenses

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Direct store expenses	\$ 250,191	\$ 216,932	\$ 33,259	15%
Percentage of net sales	20.7%	20.9%	-0.2%	

Direct store expenses for the thirteen weeks ended October 1, 2017 increased \$33.3 million, including \$26.5 million related to stores opened after October 2, 2016, and \$6.8 million related to stores operated prior to the same period in 2016. Direct store expenses, as a percentage of net sales, decreased 20 basis points. This leverage is primarily driven by improved comparable sales, as well as operating efficiencies, partially offset by higher benefit costs.

Selling, general and administrative expenses

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Selling, general and administrative expenses	\$ 39,955	\$ 29,664	\$ 10,291	35%
Percentage of net sales	3.3%	2.9%	0.4%	

The increase in selling, general and administrative expenses primarily reflects a \$7.1 million increase in bonus and compensation expenses, \$1.5 million increase in advertising expenses, and \$1.7 million of increases in other corporate expenses, commensurate with store growth and improved company performance.

Store pre-opening costs

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Attributable to 2016 store openings	—	3,109	(3,109)	
Attributable to 2017 store openings	2,046	337	1,709	
Attributable to future store openings	410	—	410	
Total store pre-opening costs	<u>\$ 2,456</u>	<u>\$ 3,446</u>	<u>\$ (990)</u>	(29)%
Percentage of net sales	0.2%	0.3%	(0.1)%	

Store pre-opening costs in the thirteen weeks ended October 1, 2017 included \$1.9 million related to opening 8 stores during the thirteen weeks ended October 1, 2017 and \$0.6 million associated with stores expected to open subsequent to October 1, 2017. Store pre-opening costs in the thirteen weeks ended October 2, 2016 included \$2.6 million related to opening 10 stores during that period and \$0.8 million associated with stores opened subsequent to quarter end.

Store closure and other costs

Store closure costs for the thirteen weeks ended October 1, 2017 and October 2, 2016 are related to adjustments to the closed store facility reserve primarily related to refinement of estimated subtenant income and other actual occupancy costs from original estimates.

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		Change	% Change
	October 1, 2017	October 2, 2016		
Capital and financing leases	\$ 3,033	\$ 2,708	\$ 325	12%
Long-term debt	2,305	786	1,519	193%
Deferred financing costs / Original issuance discount	116	116	—	0%
Other	155	113	42	37%
Total Interest Expense	<u>\$ 5,609</u>	<u>\$ 3,723</u>	<u>\$ 1,886</u>	51%

The increase in interest expense is primarily due to the higher principal balance on the Credit Facility for borrowing to support our share repurchase program, combined with the slightly higher interest rate on our Credit Facility for the thirteen weeks ended October 1, 2017.

Income tax provision

Income tax provision increased to \$16.1 million for the thirteen weeks ended October 1, 2017 from \$14.0 million for the thirteen weeks ended October 2, 2016, primarily related to an increase in income before taxes. Our effective income tax rate decreased to 33.8% in the thirteen weeks ended October 1, 2017 from 36.9% in the thirteen weeks ended October 2, 2016. The decrease in the effective tax rate was primarily due to tax return to provision adjustments for the 2016 income tax return.

Net income

	Thirteen weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net income	\$ 31,486	\$ 23,885	\$ 7,601	32%
Percentage of net sales	2.6%	2.3%	0.3%	

Net income as a percentage of net sales increased primarily due to higher sales and margins combined with a lower effective tax rate, offset in part by higher interest expense associated with the drawdown on our Credit Facility in connection with the stock buyback program.

Diluted earnings per share

	<u>Thirteen weeks ended</u>		<u>Change</u>	<u>% Change</u>
	<u>October 1, 2017</u>	<u>October 2, 2016</u>		
Diluted earnings per share	\$ 0.23	\$ 0.16	\$ 0.07	44%
Diluted weighted average shares outstanding	136,770	150,024	(13,254)	

The increase in diluted earnings per share of \$0.07 was driven by the increase in net income as well as fewer diluted shares outstanding compared to the prior year, due to the share repurchase program.

Results of Operations for Thirty-nine Weeks Ended October 1, 2017 and October 2, 2016

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	
	October 1, 2017	October 2, 2016
Unaudited Consolidated Statement of Operations Data:		
Net sales	\$ 3,520,679	\$ 3,060,685
Cost of sales, buying and occupancy	2,494,998	2,156,857
Gross profit	1,025,681	903,828
Direct store expenses	715,336	617,817
Selling, general and administrative expenses	110,312	91,482
Store pre-opening costs	10,055	11,625
Store closure and other costs	992	159
Income from operations	188,986	182,745
Interest expense	(15,447)	(10,985)
Other income	388	326
Income before income taxes	173,927	172,086
Income tax provision	(55,186)	(64,785)
Net income	<u>\$ 118,741</u>	<u>\$ 107,301</u>
Weighted average shares outstanding	136,063	149,202
Dilutive effect of equity-based awards	2,797	2,366
Weighted average shares and equivalent shares outstanding	138,860	151,568
Diluted net income per share	<u>\$ 0.86</u>	<u>\$ 0.71</u>

	Thirty-nine Weeks Ended	
	October 1, 2017	October 2, 2016
Other Operating Data:		
Comparable store sales growth	2.4%	3.4%
Stores at beginning of period	253	217
Opened	29	33
Stores at end of period	<u>282</u>	<u>250</u>

Comparison of Thirty-nine Weeks Ended October 1, 2017 to Thirty-nine Weeks Ended October 2, 2016

Net sales

	Thirty-nine Weeks Ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net sales	\$ 3,520,679	\$ 3,060,685	\$ 459,994	15%
Comparable store sales growth	2.4%	3.4%		

Net sales during the thirty-nine weeks ended October 1, 2017 totaled \$3.5 billion, increasing 15% over the same period of the prior fiscal year. Sales growth was primarily driven by solid performance in new stores opened. Comparable stores contributed approximately 87% of net sales for the thirty-nine weeks ended October 1, 2017 and approximately 88% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirty-nine Weeks Ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net sales	\$ 3,520,679	\$ 3,060,685	\$ 459,994	15%
Cost of sales, buying and occupancy	2,494,998	2,156,857	338,141	16%
Gross profit	1,025,681	903,828	121,853	13%
Gross margin	29.1%	29.5%	(0.4)%	

Gross profit increased during the thirty-nine weeks ended October 1, 2017 compared to the thirty-nine weeks ended October 2, 2016 by \$121.9 million, primarily as a result of increased sales volume. Gross margin decreased due to the competitive environment, primarily in the first half of 2017, as well as higher occupancy costs.

Direct store expenses

	Thirty-nine Weeks Ended		Change	% Change
	October 1, 2017	October 2, 2016		
Direct store expenses	\$ 715,336	\$ 617,817	\$ 97,519	16%
Percentage of net sales	20.3%	20.2%	0.1%	

Direct store expenses for the thirty-nine weeks ended October 1, 2017 increased \$97.5 million. Direct store expenses, as a percentage of net sales, increased 10 basis points. This primarily reflects higher payroll and benefit costs, in part due to deleverage of fixed costs associated with lower comparable store sales growth, partially offset by other operating efficiencies.

Selling, general and administrative expenses

	Thirty-nine Weeks Ended		Change	% Change
	October 1, 2017	October 2, 2016		
Selling, general and administrative expenses	\$ 110,312	\$ 91,482	\$ 18,830	21%
Percentage of net sales	3.1%	3.0%	0.1%	

The increase in selling, general and administrative expenses primarily reflects an \$8.1 million increase in compensation expense, a \$3.7 million increase in regional expenses, a \$3.5 million increase in advertising to support growth and \$3.5 million of increases in other corporate expenses, commensurate with store growth and improved company performance.

Store pre-opening costs

	Thirty-nine weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Attributable to 2016 store openings	—	11,186	(11,186)	
Attributable to 2017 store openings	9,210	439	8,771	
Attributable to future store openings	845	—	845	
Total store pre-opening costs	<u>\$ 10,055</u>	<u>\$ 11,625</u>	<u>\$ (1,570)</u>	(14)%
Percentage of net sales	0.3%	0.4%	(0.1)%	

Store pre-opening costs in the thirty-nine weeks ended October 1, 2017 included \$9.0 million related to opening 29 stores during the thirty-nine weeks ended October 1, 2017 and \$1.0 million associated with stores expected to open subsequent to October 1, 2017. Store pre-opening costs in the thirty-nine weeks ended October 2, 2016 included \$10.6 million related to opening 33 stores during that period and \$1.0 million associated with stores opened subsequent to quarter end.

Store closure and other costs

Store closure costs for the thirty-nine weeks ended October 1, 2017 and October 2, 2016 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 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		Change	% Change
	October 1, 2017	October 2, 2016		
Capital and financing leases	\$ 8,715	\$ 8,048	\$ 667	8%
Long-term debt	5,919	2,247	3,672	163%
Deferred financing costs / Original issuance discount	347	347	—	0%
Other	466	343	123	36%
Total Interest Expense	<u>\$ 15,447</u>	<u>\$ 10,985</u>	<u>\$ 4,462</u>	41%

The increase in interest expense is primarily due to the higher principal balance on the Credit Facility for borrowing to support our share repurchase program combined with the slightly higher interest rate on our Credit Facility for the thirty-nine weeks ended October 1, 2017.

Income tax provision

Income tax provision decreased to \$55.2 million for the thirty-nine weeks ended October 1, 2017 from \$64.8 million for the thirty-nine weeks ended October 2, 2016, primarily related to the recognition of excess tax benefits related to the exercise or vesting of equity-based awards in the income tax provision. Our effective income tax rate decreased to 31.7% in the thirty-nine weeks ended October 1, 2017 from 37.7% in the thirty-nine weeks ended October 2, 2016 primarily related to recognition of excess tax benefits related to the exercise or vesting of equity-based awards in the income tax provision. See ASU 2016-09, Compensation – “Stock Compensation (Topic 718)” under Recently Adopted Accounting Pronouncements (Note 2).

Net income

	Thirty-nine Weeks Ended		Change	% Change
	October 1, 2017	October 2, 2016		
Net income	\$ 118,741	\$ 107,301	\$ 11,440	11%
Percentage of net sales	3.4%	3.5%	(0.1)%	

Net income increased \$11.4 million as a result of increased sales, but decreased slightly as a percentage of net sales due to lower gross margin and higher payroll expenses partially offset by a lower effective tax rate.

Diluted earnings per share

	Thirty-nine weeks ended		Change	% Change
	October 1, 2017	October 2, 2016		
Diluted earnings per share	\$ 0.86	\$ 0.71	\$ 0.15	21%
Diluted weighted average shares outstanding	138,860	151,568	(12,708)	

The increase in diluted earnings per share of \$0.15 was driven by the increase in net income as well as fewer diluted shares outstanding compared to the prior year, due 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	
	October 1, 2017	October 2, 2016 (4)
	(dollars in thousands)	
Net income (1)	\$ 135,745	\$ 135,518
Interest expense, net of tax (2)	11,770	9,580
Net operating profit after tax (NOPAT)	<u>\$ 147,515</u>	<u>\$ 145,098</u>
Total rent expense, net of tax (2)	78,113	63,983
Estimated depreciation on capitalized operating leases, net of tax (2)	(34,370)	(28,153)
Estimated interest on capitalized operating leases, net of tax (2) (3)	43,743	35,830
NOPAT, including effect of capitalized operating leases	<u>\$ 191,258</u>	<u>\$ 180,928</u>
Average working capital	15,093	103,321
Average property and equipment	641,451	522,183
Average other assets	574,281	586,777
Average other liabilities	(149,039)	(115,077)
Average invested capital	<u>\$ 1,081,786</u>	<u>\$ 1,097,204</u>
Average estimated asset base of capitalized operating leases	930,645	814,532
Average invested capital, including the effect of capitalized operating leases	<u>\$ 2,012,431</u>	<u>\$ 1,911,736</u>
ROIC	<u>13.6%</u>	<u>13.2%</u>
ROIC, including the effect of capitalized operating leases	<u>9.5%</u>	<u>9.5%</u>

- (1) Net income amounts represent total net income for past four trailing quarters.
- (2) Net of tax amounts are calculated using the effective tax rate for the period presented.
- (3) Interest on capitalized leases is calculated as the trailing four quarters' rent expense multiplied by eight and by a seven percent interest rate factor.
- (4) Inclusive of \$4.1 million net income benefit of 53rd week in 2015.

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 and cash equivalents at the end of each period (in thousands):

	Thirty-nine weeks ended	
	October 1, 2017	October 2, 2016
Cash and cash equivalents at end of period	\$ 18,892	\$ 50,290
Cash flows from operating activities	\$ 258,969	\$ 196,037
Cash flows used in investing activities	\$ (158,429)	\$ (142,400)
Cash flows used in financing activities	\$ (94,113)	\$ (139,416)

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 and cash equivalents, 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 Credit Facility 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 and cash

equivalents 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 increased \$63.0 million to \$259.0 million for the thirty-nine weeks ended October 1, 2017 compared to \$196.0 million for the thirty-nine weeks ended October 2, 2016. The cash flows from operating activities came from net income adjusted primarily for non-cash expenses of depreciation and amortization, deferred income taxes, equity-based compensation and changes in working capital.

Cash flows provided by operating activities from changes in working capital was \$34.4 million in the thirty-nine weeks ended October 1, 2017, compared to \$2.5 million use of cash in the thirty-nine weeks ended October 2, 2016. The increase in cash flows from operating activities for changes in working capital in the thirty-nine weeks ended October 1, 2017, compared to the thirty-nine weeks ended October 2, 2016, was primarily due to higher net income combined with working capital improvements as a result of operating efficiencies achieved through our strategic initiatives, and higher payroll and bonus accruals in line with improved performance and company growth.

Investing Activities

Cash flows used in investing activities were \$158.4 million, and \$142.4 million for the thirty-nine weeks ended October 1, 2017 and the thirty-nine weeks ended October 2, 2016, respectively. The increase in cash flows used in investing activities is primarily due to additional purchases of property and equipment, due to the addition of 32 stores in the last twelve months. 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.

We expect capital expenditures to be approximately \$170 million in fiscal 2017, 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 Credit Facility.

Financing Activities

Cash flows used in financing activities were \$94.1 million for the thirty-nine weeks ended October 1, 2017 compared to \$139.4 million for the thirty-nine weeks ended October 2, 2016. During the thirty-nine weeks ended October 1, 2017, cash flows used in financing activities consisted of \$192.0 million for stock repurchases, \$40.0 million in payments on our Credit Facility, \$3.0 million cash paid for capital and financing lease obligations, partially offset by \$134.0 million of borrowings on the Credit Facility, \$6.6 million in proceeds from the exercise of stock options and \$0.3 million of cash received from landlords related to financing lease obligations.

During the thirty-nine weeks ended October 2, 2016, cash flows used in financing activities consisted of \$187.8 million for stock repurchases and \$3.1 million cash paid for capital and financing lease obligations, partially offset by \$45.0 million of borrowings on the Credit Facility \$3.9 million of excess tax benefits from the exercise of stock options and \$2.6 million in proceeds from the exercise of stock options.

Long-Term Debt and Credit Facilities

Long-term debt increased \$144.0 million to \$349.0 million as of October 1, 2017, compared to October 2, 2016 primarily related to borrowings to fund our share repurchase programs.

See Note 4 "Long-Term Debt" of our unaudited consolidated financial statements for a description of our Credit Facility.

Share Repurchase Program

On November 4, 2015, our board of directors authorized a \$150 million common stock share repurchase program, which was completed during the second quarter of 2016. On September 6, 2016, our board of directors authorized a \$250 million share repurchase program for our common stock, which was completed during the first quarter of 2017. On February 20, 2017, our board of directors authorized a new \$250 million share repurchase program for our common stock. The following table outlines the share repurchase programs authorized by the Board, and the related repurchase activity and available authorization as of October 1, 2017.

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	\$ 112,000	\$ 138,000

The shares under the 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 us 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 Facility to assist with the repurchase program authorized on September 6, 2016 and February 20, 2017.

Share repurchase activity under our repurchase programs for the periods indicated was as follows:

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	October 1, 2017	October 2, 2016	October 1, 2017	October 2, 2016
Number of common shares acquired	3,249,204	3,189,818	9,136,468	8,169,510
Average price per common share acquired	\$ 22.16	\$ 19.93	\$ 21.01	\$ 22.99
Total cost of common shares acquired	\$ 72,000	\$ 63,572	\$ 192,000	\$ 187,836

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 2035.

The following table summarizes our lease obligations as of October 1, 2017, 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 Year	1-3 Years	4-5 Years	More Than 5 Years
	(in thousands)				
Capital and financing lease obligations (1)	\$ 142,221	\$ 17,018	\$ 33,472	\$ 31,175	\$ 60,556
Operating lease obligations (1)	1,590,493	138,329	302,886	287,356	861,922
Totals	\$ 1,732,714	\$ 155,347	\$ 336,358	\$ 318,531	\$ 922,478

- (1) Represents estimated payments for capital and financing and operating lease obligations as of October 1, 2017. 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, \$2.4 million for years one to three, \$1.7 million for years four to five, and \$1.7 million for the period beyond five years.

We have other contractual purchase commitments and debt, which were presented under Contractual Obligations in our Annual Report on Form 10-K for the fiscal year ended January 1, 2017. There have not been material changes to our contractual purchase commitments since that filing through October 1, 2017. As of October 1, 2017, the outstanding balance on the Credit Facility was \$349.0 million, as discussed in Note 4 to the unaudited consolidated financial statements.

We periodically make other commitments and become subject to other contractual obligations that we believe to be routine in nature and incidental to the operation of the business. Management believes that such routine commitments and contractual obligations do not have a material impact on our business, financial condition or results of operations.

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 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 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 October 1, 2017. 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 January 1, 2017.

Recently Issued Accounting Pronouncements

See Note 2 "Recently Issued Accounting Pronouncements" 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 a Credit Facility that bears interest at a rate based in part on LIBOR. Accordingly, we are exposed to fluctuations in interest rates. Based on the \$349.0 million principal outstanding under our Credit Facility as of October 1, 2017, each hundred basis point change in LIBOR would result in a change in interest expense by \$3.5 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.

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 October 1, 2017, 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 October 1, 2017, 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, 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 plaintiffs sought remand, which the court granted in March 2017. We have appealed the order granting remand to the Ninth Circuit Court of Appeals. On May 25, 2017, we 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. We answered the complaint on September 28, 2017. We 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.

"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 which is likely to be dispositive on the question of whether the arbitration agreements signed by each of the named plaintiffs are enforceable; oral argument in this case was heard by the U.S. Supreme Court on October 2, 2017, and we do not expect a decision from the U.S. Supreme Court until Spring 2018. We will continue 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.

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 January 1, 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 thirteen weeks ended October 1, 2017.

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 programs
July 3, 2017 - July 30, 2017	675,727	\$ 23.01	675,727	\$ 194,450,000
July 31, 2017 - August 27, 2017	1,017,618	\$ 24.03	1,017,618	\$ 170,000,000
August 28, 2017 - October 1, 2017	1,555,859	\$ 20.57	1,555,859	\$ 138,000,000

(1) Periodic information is presented by reference to our fiscal periods during the third quarter of fiscal year 2017.

Item 6. Exhibits.

Exhibit Number	Description
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

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 2, 2017

By: /s/ Bradley S. Lukow
Name: Bradley S. Lukow
Title: Chief Financial Officer
(Principal Financial Officer)

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Section 2: EX-31.1 (EX-31.1)

Exhibit 31.1

CERTIFICATION OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Amin N. Maredia, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Sprouts Farmers Market, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2017

/s/ Amin N. Maredia

Amin N. Maredia
Chief Executive Officer
(Principal Executive Officer)

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Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

CERTIFICATION OF CHIEF FINANCIAL OFFICER PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Bradley S. Lukow, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Sprouts Farmers Market, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: November 2, 2017

/s/ Bradley S. Lukow

Bradley S. Lukow
Chief Financial Officer
(Principal Financial Officer)

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Section 4: EX-32.1 (EX-32.1)

Exhibit 32.1

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report of Sprouts Farmers Market, Inc. (the "Company"), on Form 10-Q for the quarterly period ended October 1, 2017 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Amin N. Maredia, Chief Executive Officer of the Company, certify, based on my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 2, 2017

/s/ Amin N. Maredia

Amin N. Maredia

Chief Executive Officer

(Principal Executive Officer)

This certification accompanies the Report to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

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Section 5: EX-32.2 (EX-32.2)

Exhibit 32.2

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO SECTION 906
OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the quarterly report of Sprouts Farmers Market, Inc. (the "Company"), on Form 10-Q for the quarterly period ended October 1, 2017 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Bradley S. Lukow, Chief Financial Officer of the Company, certify, based on my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)); and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 2, 2017

/s/ Bradley S. Lukow

Bradley S. Lukow

Chief Financial Officer

(Principal Financial Officer)

This certification accompanies the Report to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-Q), irrespective of any general incorporation language contained in such filing.

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