

Sprouts Farmers Market, Inc.
Form 10-Q
August 03, 2017
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended July 2, 2017

Commission File Number: 001-36029

Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

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

incorporation or organization) Identification No.)

5455 East High Street, Suite 111

Phoenix, Arizona 85054

(Address of principal executive offices and zip code)

(480) 814-8016

(Registrant's telephone number, including area code)

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

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

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(§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company) Smaller reporting company

Emerging growth company

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

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

As of August 1, 2017, the registrant had 135,577,182 shares of common stock, \$0.001 par value per share, outstanding.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JULY 2, 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,” “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

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	July 2, 2017	January 1, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 14,814	\$ 12,465
Accounts receivable, net	19,782	25,228
Inventories	218,404	204,464
Prepaid expenses and other current assets	23,409	21,869
Total current assets	276,409	264,026
Property and equipment, net of accumulated depreciation	681,065	604,660
Intangible assets, net of accumulated amortization	196,906	197,608
Goodwill	368,078	368,078
Other assets	7,751	5,521
Total assets	\$ 1,530,209	\$ 1,439,893
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 181,913	\$ 157,550
Accrued salaries and benefits	34,910	32,859
Other accrued liabilities	50,150	56,376
Current portion of capital and financing lease obligations	14,870	12,370
Total current liabilities	281,843	259,155
Long-term capital and financing lease obligations	124,749	117,366
Long-term debt	310,000	255,000
Other long-term liabilities	123,957	116,200
Deferred income tax liability	37,302	19,263
Total liabilities	877,851	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,		
136,242,909 and 140,256,313 shares issued and outstanding,		
July 2, 2017 and January 1, 2017, respectively	136	140
Additional paid-in capital	609,461	597,269

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Retained earnings	42,761	75,500
Total stockholders' equity	652,358	672,909
Total liabilities and stockholders' equity	\$1,530,209	\$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		Twenty-six Weeks Ended	
	July 2,	July 3,	July 2,	July 3,
	2017	2016	2017	2016
Net sales	\$1,183,975	\$1,031,643	\$2,314,620	\$2,024,884
Cost of sales, buying and occupancy	841,989	725,841	1,635,348	1,412,569
Gross profit	341,986	305,802	679,272	612,315
Direct store expenses	236,185	207,205	465,334	401,020
Selling, general and administrative expenses	38,189	30,922	70,357	61,818
Store pre-opening costs	4,141	4,213	7,599	8,179
Income from operations	63,471	63,462	135,982	141,298
Interest expense	(5,100)	(3,661)	(9,838)	(7,262)
Other income	131	90	226	191
Income before income taxes	58,502	59,891	126,370	134,227
Income tax provision	(17,534)	(22,682)	(39,115)	(50,811)
Net income	\$40,968	\$37,209	\$87,255	\$83,416
Net income per share:				
Basic	\$0.30	\$0.25	\$0.64	\$0.56
Diluted	\$0.29	\$0.25	\$0.62	\$0.55
Weighted average shares outstanding:				
Basic	136,796	149,170	136,933	149,931
Diluted	139,493	151,498	139,847	152,322

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)

		Common	Additional Paid In	Retained	Total Stockholders'
	Shares	Stock	Capital	Earnings	Equity
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	—	—	—	87,255	87,255
Issuance of shares under stock plans	1,692,542	2	5,953	—	5,955
Repurchase and retirement of common stock	(5,887,264)	(6)	—	(119,994)	(120,000)
Equity-based compensation	—	—	6,239	—	6,239
Balances at July 2, 2017	135,807,520	\$ 136	\$ 609,461	\$ 42,761	\$ 652,358

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(IN THOUSANDS)

	Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016
Cash flows from operating activities		
Net income	\$87,255	\$83,416
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	46,142	38,813
Accretion of asset retirement obligation and closed store reserve	94	176
Amortization of financing fees and debt issuance costs	231	231
Loss on disposal of property and equipment	356	57
Equity-based compensation	6,239	6,325
Deferred income taxes	18,039	13,590
Changes in operating assets and liabilities:		
Accounts receivable	4,106	3,015
Inventories	(13,940)	(23,731)
Prepaid expenses and other current assets	(1,549)	3,334
Other assets	(2,450)	(4,961)
Accounts payable	31,234	24,768
Accrued salaries and benefits	2,051	(2,038)
Other accrued liabilities and income taxes payable	(6,238)	(7,395)
Other long-term liabilities	8,313	12,340
Cash flows from operating activities	179,883	147,940
Cash flows from investing activities		
Purchases of property and equipment	(117,753)	(85,081)
Proceeds from sale of property and equipment	30	662
Purchase of leasehold interests	—	(491)
Cash flows used in investing activities	(117,723)	(84,910)
Cash flows from financing activities		
Proceeds from revolving credit facility	85,000	—
Payments on revolving credit facility	(30,000)	—
Payments on capital and financing lease obligations	(2,068)	(2,130)
Cash from landlords related to financing lease obligations	1,325	—
Repurchase of common stock	(120,000)	(124,265)
Proceeds from exercise of stock options	5,932	2,053
Excess tax benefit for exercise of stock options	—	3,687
Cash flows used in financing activities	(59,811)	(120,655)
(Decrease) / Increase in cash and cash equivalents	2,349	(57,625)
Cash and cash equivalents at beginning of the period	12,465	136,069
Cash and cash equivalents at the end of the period	\$14,814	\$78,444

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Supplemental disclosure of cash flow information

Cash paid for interest	\$9,438	\$7,297
Cash paid for income taxes	19,595	28,575

Supplemental disclosure of non-cash investing and financing activities

Property and equipment in accounts payable	\$16,358	\$32,183
Property acquired through capital and financing lease obligations	9,774	4,655

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 twenty-six weeks ended July 2, 2017 (see Note 11). 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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments.” This update provides clarifications on the cash flow classification for eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The 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.

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 twenty-six weeks ended July 2, 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 capital, reduced by estimated sublease rentals. The weighted average cost of capital was estimated using

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SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 July 2, 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 July 2, 2017	January 1, 2017
Senior secured debt				
\$450.0 million Credit Facility	April 17, 2020	Variable	\$310,000	\$255,000
Total debt			310,000	255,000
Long-term debt			\$310,000	\$255,000

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 July 2, 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 0.25% 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 July 2, 2017, the Company borrowed \$25.0 million and did not make any principal payments. During the twenty-six weeks ended July 2, 2017, the Company borrowed \$85.0 million and made a total of \$30.0 million of principal payments; resulting in total outstanding debt under the Credit Facility of \$310.0 million as of July 2, 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 on the last day of each fiscal quarter.

The Company was in compliance with all applicable covenants under the Credit Facility as of July 2, 2017.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

5. Closed Store Reserves

The following is a summary of closed store reserve activity during the twenty-six weeks ended July 2, 2017 and fiscal year 2016:

	Twenty-six	Fiscal
	Weeks Ended	Year Ended
	July 2, 2017	January 1, 2017
Beginning balance	\$ 1,083	\$ 2,017
Additions	—	—
Usage	(281)	(998)
Adjustments	187	64
Ending balance	\$ 989	\$ 1,083

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. Adjustments are recorded in Direct store expenses in the consolidated statements of operations.

6. Income Taxes

The Company's effective tax rate for the thirteen weeks ended July 2, 2017 and July 3, 2016 was 30.0% and 37.9%, 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).

The Company's effective tax rate for the twenty-six weeks ended July 2, 2017 and July 3, 2016 was 31.0% and 37.9%, 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 \$4.4 million for the thirteen weeks ended July 2, 2017. The income tax benefits resulting from the equity-based awards for the thirteen weeks ended July 3, 2016 were

\$0.1 million and recorded in Additional Paid-in Capital.

The income tax benefits resulting from equity-based awards were \$8.2 million for the twenty-six weeks ended July 2, 2017. The income tax benefits resulting from equity-based awards for the twenty-six weeks ended July 3, 2016 were \$3.7 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 July 2, 2017 and July 3, 2016, purchases from this supplier were \$2.7 million and \$2.7 million, respectively. During the twenty-six weeks ended July 2, 2017 and July 3, 2016, purchases from this supplier were \$5.4 million and \$5.2 million, respectively. As of July 2, 2017, and July 3, 2016, the Company had recorded accounts payable due to this vendor of \$0.8 million and \$0.9 million, 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 July 2, 2017 and July 3, 2016, purchases from this supplier and its predecessors were \$2.1 million and \$2.5 million, respectively. During the twenty-six weeks ended July 2, 2017 and July 3, 2016, purchases

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from this supplier and its predecessors were \$3.7 million and \$3.8 million, respectively. As of July 2, 2017, and July 3, 2016, the Company had recorded accounts payable due to the supplier of \$0.3 million and \$0.7 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, as amended, based on an alleged failure by the Company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint seeks damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. On March 24, 2016, the Company removed the action to federal court in the District of Arizona. On March 24, 2017, the federal court in the District of Arizona remanded the case to state court. On April 21, 2017, the Company filed a Notice of Appeal of the federal court decision to remand the case. On May 16, 2017, the Plaintiff filed a Motion to Dismiss Appeal in the Ninth Circuit Court of Appeals, which is fully briefed and under consideration. On May 25, 2017, the Company filed a Motion to Dismiss in the Superior Court for the State of Arizona, which is also fully briefed. The Company intends 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 July 2, 2017.

		Amount	Cost of	Authorization
Effective date	Expiration date	authorized	repurchases	available
November 4, 2015	November 4, 2017	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	\$ 250,000	\$ 250,000	\$ —
February 20, 2017	December 31, 2018	\$ 250,000	\$ 40,000	\$ 210,000

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 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).

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Share repurchase activity under the Company's repurchase programs for the periods indicated was as follows:

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Number of common shares acquired	1,787,328	2,547,971	5,887,264	4,979,692
Average price per common share acquired	\$22.38	\$25.49	\$20.38	\$24.95
Total cost of common shares acquired	\$40,000	\$64,957	\$120,000	\$124,265

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

10. Net Income Per Share

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

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Basic net income per share:				
Net income	\$40,968	\$37,209	\$87,255	\$83,416
Weighted average shares outstanding	136,796	149,170	136,933	149,931
Basic net income per share	\$0.30	\$0.25	\$0.64	\$0.56
Diluted net income per share:				
Net income	\$40,968	\$37,209	\$87,255	\$83,416
Weighted average shares outstanding - basic	136,796	149,170	136,933	149,931

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Dilutive effect of equity-based awards:

Assumed exercise of options to purchase shares	2,428	2,289	2,693	2,321
RSUs	102	8	103	44
RSAs	112	—	75	—
PSAs	55	31	43	26
Weighted average shares and equivalent				
shares outstanding	139,493	151,498	139,847	152,322
Diluted net income per share	\$0.29	\$0.25	\$0.62	\$0.55

For the thirteen weeks ended July 2, 2017, the computation of diluted net income per share does not include 1.6 million options, 0.1 million RSUs and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards. For the thirteen weeks ended July 3, 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.

For the twenty-six weeks ended July 2, 2017, the computation of diluted net income per share does not include 1.9 million options and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards. For the twenty-six weeks ended July 3, 2016, the computation of diluted net income per share does not include 1.3 million options, 0.1 million RSUs, 0.2 million RSAs, and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

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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 July 2, 2017, there were 3,757,776 stock awards outstanding and 5,796,037 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 July 2, 2017, there were 2,430,497 options outstanding under the 2011 Option Plan.

Awards Granted

During the twenty-six weeks ended July 2, 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	—	—
Total:	347,226	148,944	288,746
Weighted-average grant date fair value	\$18.50	\$18.11	\$18.11
Weighted-average exercise price	—	—	—

Stock Options

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

Time-based options granted prior to fiscal year 2016 generally vest ratably over a period of 12 quarters (three years), and time-based options granted in fiscal year 2016 vest annually over a period of three years.

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.

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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 twenty-six weeks ended July 3, 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 twenty-six weeks ended July 2, 2017, 21,050 of the 2015 PSAs were vested. No PSAs vested during the twenty-six weeks ended July 3, 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. 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 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 \$1.0 million during the thirteen week period and \$2.0 million during the twenty-six week period ended July 2, 2017 related to the options and RSAs granted. The Company recognized \$0.4 million in each of the thirteen and twenty-six week periods ended July 3, 2016 related to the options and RSAs granted.

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Equity-based Compensation Expense

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

	Thirteen Weeks Ended		Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Cost of sales, buying and occupancy	\$266	\$264	\$512	\$482
Direct store expenses	387	359	748	676
Selling, general and administrative expenses	3,140	3,045	4,979	5,167
Equity-based compensation expense before income taxes	3,793	3,668	6,239	6,325
Income tax benefit	(1,419)	(1,394)	(2,334)	(2,403)
Net equity-based compensation expense	\$2,374	\$2,274	\$3,905	\$3,922

The following equity-based awards were outstanding as of July 2, 2017 and January 1, 2017:

	As of	
	July 2, 2017	January 1, 2017
	(in thousands)	
Options		
Vested	4,329	5,552
Unvested	754	1,205
RSUs	459	274
PSAs	231	159
RSAs	414	187

As of July 2, 2017, total unrecognized compensation expense related to outstanding equity-based awards was as follows:

	As of July 2, 2017
Options	\$4,729
RSUs	8,026
PSAs	2,487
RSAs	7,173
Total unrecognized compensation expense	\$22,415

As of July 2, 2017, the total remaining weighted average recognition period related to outstanding equity-based awards was as follows:

	As of July 2, 2017
Options	1.2
RSUs	1.9
PSAs	1.9
RSAs	2.2

During the twenty-six weeks ended July 2, 2017 and July 3, 2016, the Company received \$5.9 million and \$2.1 million, respectively, in cash proceeds from the exercise of options.

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12. Subsequent Event

Subsequent to July 2, 2017 and through August 2, 2017, the Company repurchased an additional 0.7 million shares of common stock for \$15.5 million. The Company borrowed an additional \$15.0 million under its Credit Facility that was utilized in these repurchases, and made a \$10.0 million principal payment, resulting in total outstanding debt under the Credit Facility of \$315.0 million as of August 2, 2017.

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 274 stores in 15 states as of July 2, 2017, we are one of the largest specialty retailers of fresh, natural and organic food in the United States. As of August 1, 2017, we have grown to 278 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 July 2, 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 25 have opened through August 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 July 2, 2017 and July 3, 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	
	July 2, 2017	July 3, 2016
Unaudited Consolidated Statement of Operations Data:		
Net sales	\$1,183,975	\$1,031,643
Cost of sales, buying and occupancy	841,989	725,841
Gross profit	341,986	305,802
Direct store expenses	236,185	207,205
Selling, general and administrative expenses	38,189	30,922
Store pre-opening costs	4,141	4,213
Income from operations	63,471	63,462
Interest expense	(5,100)	(3,661)
Other income	131	90
Income before income taxes	58,502	59,891
Income tax provision	(17,534)	(22,682)
Net income	\$40,968	\$37,209
Weighted average shares outstanding	136,796	149,170
Dilutive effect of equity-based awards	2,697	2,328
Weighted average shares and equivalent shares outstanding	139,493	151,498
Diluted net income per share	\$0.29	\$0.25

	Thirteen weeks ended	
	July 2, 2017	July 3, 2016
Other Operating Data:		
Comparable store sales growth	1.4 %	4.1 %
Stores at beginning of period	261	228
Closed	—	—
Opened	13	12
Stores at end of period	274	240

Comparison of Thirteen Weeks Ended July 2, 2017 to Thirteen Weeks Ended

July 3, 2016

Net sales

	Thirteen weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change
Net sales	\$1,183,975	\$1,031,643	\$152,332	15 %
Comparable store sales growth	1.4	% 4.1	%	

Net sales during the thirteen weeks ended July 2, 2017 totaled \$1.2 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 86% of total sales for the thirteen weeks ended July 2, 2017 and approximately 88% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirteen weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change
Net sales	\$1,183,975	\$1,031,643	\$152,332	15 %
Cost of sales, buying and occupancy	841,989	725,841	116,148	16 %
Gross profit	341,986	305,802	36,184	12 %
Gross margin	28.9	% 29.6	% -0.7	%

Gross profit increased during the thirteen weeks ended July 2, 2017 compared to the thirteen weeks ended July 3, 2016 by \$36.2 million, of which \$44.7 million was as a result of increased sales volume, partially offset by \$8.5 million related to decreased margin rate. This primarily reflects the impact of modest cost inflation coupled with the ongoing competitive environment, and higher occupancy costs.

Direct store expenses

	Thirteen weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change

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Direct store expenses	\$236,185	\$207,205	\$28,980	14	%	
Percentage of net sales	19.9	%	20.1	%	-0.2	%

Direct store expenses for the thirteen weeks ended July 2, 2017 increased \$29.0 million, including \$26.3 million related to stores opened after July 3, 2016, and \$2.7 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 primarily reflects our strategic focus on labor productivity improvement and operating efficiencies, partially offset by higher benefit costs.

Selling, general and administrative expenses

	Thirteen weeks ended					
	July 2, 2017	July 3, 2016	Change	% Change		
Selling, general and administrative expenses	\$38,189	\$30,922	\$7,267	24	%	
Percentage of net sales	3.2	%	3.0	%	0.2	%

The increase in selling, general and administrative expenses included a \$2.6 million increase in compensation expenses, a \$1.7 million increase in advertising expenses, a \$1.0 million increase in regional expenses, and \$2.0 million of increases in other corporate expenses, commensurate with store growth.

Store pre-opening costs

	Thirteen weeks ended		Change	% Change
	July 2, 2017	July 3, 2016		
Attributable to 2016 store openings	—	4,213	(4,213)	
Attributable to 2017 store openings	2,786	—	2,786	
Attributable to planned 2017 store openings	1,355	—	1,355	
Total store pre-opening costs	\$4,141	\$4,213	\$(72)	(2)%
Percentage of net sales	0.3%	0.4%	(0.1)%	

Store pre-opening costs in the thirteen weeks ended July 2, 2017 included \$2.8 million related to opening 13 stores during the thirteen weeks ended July 2, 2017 and \$1.3 million associated with stores expected to open subsequent to July 2, 2017. Store pre-opening costs in the thirteen weeks ended July 3, 2016 included \$2.5 million related to opening 12 stores during that period and \$1.7 million associated with stores opened subsequent to quarter end.

Interest expense

	Thirteen weeks ended		Change	% Change
	July 2, 2017	July 3, 2016		
Capital and financing leases	\$2,869	\$2,685	\$184	7%
Long-term debt	1,949	745	1,204	162%
Deferred financing costs / Original issuance discount	116	116	—	0%
Other	166	115	51	44%
Total Interest Expense	\$5,100	\$3,661	\$1,439	39%

The increase in interest expense is 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 July 2, 2017.

Income tax provision

Income tax provision decreased to \$17.5 million for the thirteen weeks ended July 2, 2017 from \$22.7 million for the thirteen weeks ended July 3, 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 and a decrease in income before taxes. Our effective income tax rate decreased to 30.0% in the thirteen weeks ended July 2, 2017 from 37.9% in the thirteen weeks ended July 3, 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

	Thirteen weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change
Net income	\$40,968	\$37,209	\$3,759	10 %
Percentage of net sales	3.5 %	3.6 %	(0.1)%	

Net income as a percentage of net sales decreased slightly due to lower gross margin and higher selling, general and administrative expenses partially offset by a lower effective tax rate.

Diluted earnings per share

	Thirteen weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change
Diluted earnings per share	\$0.29	\$0.25	\$0.04	16 %
Diluted weighted average shares				
outstanding	139,493	151,498	(12,005)	

The increase in diluted earnings per share of \$0.04 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 Twenty-six Weeks Ended July 2, 2017 and July 3, 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.

	Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016
Unaudited Consolidated Statement of Operations Data:		
Net sales	\$2,314,620	\$2,024,884
Cost of sales, buying and occupancy	1,635,348	1,412,569
Gross profit	679,272	612,315
Direct store expenses	465,334	401,020
Selling, general and administrative expenses	70,357	61,818
Store pre-opening costs	7,599	8,179
Income from operations	135,982	141,298
Interest expense	(9,838)	(7,262)
Other income	226	191
Income before income taxes	126,370	134,227
Income tax provision	(39,115)	(50,811)
Net income	\$87,255	\$83,416
Weighted average shares outstanding	136,933	149,931
Dilutive effect of equity-based awards	2,914	2,391
Weighted average shares and equivalent shares outstanding	139,847	152,322
Diluted net income per share	\$0.62	\$0.55

	Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016
Other Operating Data:		
Comparable store sales growth	1.2 %	4.4 %
Stores at beginning of period	253	217
Closed	—	—
Opened	21	23
Stores at end of period	274	240

Comparison of Twenty-six Weeks Ended July 2, 2017 to Twenty-six Weeks Ended

July 3, 2016

Net sales

	Twenty-six Weeks Ended		Change	% Change
	July 2, 2017	July 3, 2016		
Net sales	\$2,314,620	\$2,024,884	\$289,736	14 %
Comparable store sales growth	1.2	% 4.4	%	

Net sales during the twenty-six weeks ended July 2, 2017 totaled \$2.3 billion, increasing 14% 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 86% of total sales for the twenty-six weeks ended July 2, 2017 and approximately 88% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Twenty-six Weeks Ended		Change	% Change
	July 2, 2017	July 3, 2016		
Net sales	\$2,314,620	\$2,024,884	\$289,736	14 %
Cost of sales, buying and occupancy	1,635,348	1,412,569	222,779	16 %
Gross profit	679,272	612,315	66,957	11 %
Gross margin	29.3	% 30.2	% (0.9)%

Gross profit increased during the twenty-six weeks ended July 2, 2017 compared to the twenty-six weeks ended July 3, 2016 by \$67.0 million, of which \$86.7 million was as a result of increased sales volume, partially offset by \$19.7 million related to decreased margin rate. This primarily reflects the ongoing competitive environment, as well as higher occupancy costs.

Direct store expenses

Twenty-six Weeks
Ended

Change % Change

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	July 2, 2017	July 3, 2016			
Direct store expenses	\$465,334	\$401,020	\$64,314	16	%
Percentage of net sales	20.1	% 19.8	% 0.3		%

Direct store expenses for the twenty-six weeks ended July 2, 2017 increased \$64.3 million, including \$41.4 million related to stores opened after July 3, 2016, and \$22.9 million related to stores operated prior to the same period in 2016. Direct store expenses, as a percentage of net sales, increased 30 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

	Twenty-six Weeks Ended				
	July 2, 2017	July 3, 2016	Change	% Change	
Selling, general and administrative expenses	\$70,357	\$61,818	\$8,539	14	%
Percentage of net sales	3.0	% 3.1	% (0.1)		%

The increase in selling, general and administrative expenses included a \$2.6 million increase in compensation expense, a \$2.0 million increase in advertising to support growth, a \$2.0 million increase in regional expense and \$1.9 million of increases in other corporate expenses, commensurate with store growth.

Store pre-opening costs

	Twenty-six weeks ended		Change	% Change
	July 2, 2017	July 3, 2016		
Attributable to 2016 store openings	—	8,179	(8,179)	
Attributable to 2017 store openings	6,178	—	6,178	
Attributable to planned 2017 store openings	1,421	—	1,421	
Total store pre-opening costs	\$7,599	\$8,179	\$(580)	(7)%
Percentage of net sales	0.3%	0.4%	(0.1)%	

Store pre-opening costs in the twenty-six weeks ended July 2, 2017 included \$6.2 million related to opening 21 stores during the twenty-six weeks ended July 2, 2017 and \$1.4 million associated with stores expected to open subsequent to July 2, 2017. Store pre-opening costs in the twenty-six weeks ended July 3, 2016 included \$5.7 million related to opening 23 stores during that period and \$2.5 million associated with stores opened subsequent to quarter end.

Interest expense

	Twenty-six weeks ended		Change	% Change
	July 2, 2017	July 3, 2016		
Capital and financing leases	\$5,680	\$5,339	\$341	6%
Long-term debt	3,614	1,461	2,153	147%
Deferred financing costs / Original issuance discount	231	231	—	0%
Other	313	231	82	35%
Total Interest Expense	\$9,838	\$7,262	\$2,576	35%

The increase in interest expense is 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 July 2, 2017.

Income tax provision

Income tax provision decreased to \$39.1 million for the twenty-six weeks ended July 2, 2017 from \$50.8 million for the twenty-six weeks ended July 3, 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 and a decrease in income before taxes. Our effective income tax rate decreased to 31.0% in the twenty-six weeks ended July 2, 2017 from 37.9% in the twenty-six weeks ended July 3, 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

	Twenty-six Weeks Ended					
	July 2, 2017	July 3, 2016	Change	% Change		
Net income	\$87,255	\$83,416	\$3,839	5	%	
Percentage of net sales	3.8	4.1	(0.3)		%	%

Net income as a percentage of net sales decreased due to lower gross margin and higher payroll expenses partially offset by a lower effective tax rate.

Diluted earnings per share

	Twenty-six weeks ended			
	July 2, 2017	July 3, 2016	Change	% Change
Diluted earnings per share	\$0.62	\$0.55	\$0.07	13 %
Diluted weighted average shares				
outstanding	139,847	152,322	(12,475)	

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.

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		
	July 2, 2017	July 3, 2016 (4)	
	(dollars in thousands)		
Net income (1)	\$128,145	\$143,619	
Interest expense, net of tax (2)	9,971	9,502	
Net operating profit after tax (NOPAT)	\$138,116	\$153,121	
Total rent expense, net of tax (2)	75,148	60,010	
Estimated depreciation on capitalized operating leases, net of tax (2)	(33,065)	(26,405)	
Estimated interest on capitalized operating leases, net of tax (2) (3)	42,083	33,605	
NOPAT, including effect of capitalized operating leases	\$180,199	\$186,726	
Average working capital	25,019	118,062	
Average property and equipment	613,244	501,691	
Average other assets	578,201	586,795	
Average other liabilities	(139,642)	(113,065)	
Average invested capital	\$1,076,822	\$1,093,483	
Average estimated asset base of capitalized operating leases	905,823	764,655	
Average invested capital, including the effect of capitalized operating leases	\$1,982,645	\$1,858,138	
ROIC	12.8	% 14.0	%
ROIC, including the effect of capitalized operating leases	9.1	% 10.0	%

(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):

	Thirteen weeks ended	
	July 2, 2017	July 3, 2016
Cash and cash equivalents at end of period	\$14,814	\$78,444

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Cash flows from operating activities	\$179,883	\$147,940
Cash flows used in investing activities	\$(117,723)	\$(84,910)
Cash flows used in financing activities	\$(59,811)	\$(120,655)

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 \$32.0 million to \$179.9 million for the twenty-six weeks ended July 2, 2017 compared to \$147.9 million for the twenty-six weeks ended July 3, 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 \$21.5 million in the twenty-six weeks ended July 2, 2017, compared to \$5.3 million in the twenty-six weeks ended July 3, 2016. The increase in cash flows from operating activities for changes in working capital in the twenty-six weeks ended July 2, 2017, compared to the twenty-six weeks ended July 3, 2016, was primarily due to less cash used for accounts payable and inventory.

Investing Activities

Cash flows used in investing activities were \$117.7 million, and \$84.9 million for the twenty-six weeks ended July 2, 2017 and the twenty-six weeks ended July 3, 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 34 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 in the range of \$155 - \$165 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 \$59.8 million for the twenty-six weeks ended July 2, 2017 compared to \$120.7 million for the twenty-six weeks ended July 3, 2016. During the twenty-six weeks ended July 2, 2017, cash flows used in financing activities consisted of \$120.0 million for stock repurchases, \$30.0 million in payments on our Credit Facility, \$2.0 million cash paid for capital and financing lease obligations, partially offset by \$85.0 million of borrowings on the Credit Facility, \$5.9 million in proceeds from the exercise of stock options and \$1.3 million of cash received from landlords related to financing lease obligations.

During the twenty-six weeks ended July 3, 2016, cash flows used in financing activities consisted of \$124.3 million for stock repurchases and \$2.1 million cash paid for capital and financing lease obligations, partially offset by \$3.7 million of excess tax benefits from the exercise of stock options and \$2.0 million in proceeds from the exercise of stock options.

Long-Term Debt and Credit Facilities

Long-term debt increased \$150.0 million to \$310.0 million as of July 2, 2017, compared to July 3, 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.

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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 July 2, 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	\$ 40,000	\$ 210,000

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		Twenty-six Weeks Ended	
	July 2, 2017	July 3, 2016	July 2, 2017	July 3, 2016
Number of common shares acquired	1,787,328	2,547,971	5,887,264	