Blue Buffalo Pet Products, Inc.
Form 10-K
February 26, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

ý ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2017

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE TRANSITION PERIOD FROM TO

Commission File No. 001-37510

BLUE BUFFALO PET PRODUCTS, INC.
(Exact Name of Registrant as Specified in Its Charter)

| | |
|---|---|
| Delaware | 46-0552933 |
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |
| 11 River Road, Wilton, CT | 06897 |
| (Address of Principal Executive Offices) | (Zip Code) |

(203) 762-9751
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

| Title of Each Class | Name of Each Exchange on Which Registered |
|---|---|
| Common Stock, $0.01 par value | The NASDAQ Stock Market LLC |

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ý No ¨.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No ý.

Indicate by check mark whether 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 ý No ¨.

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 ý No ¨.

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or 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 ý Accelerated filer ¨ Smaller reporting company ¨
Non-accelerated filer ¨ (Do not check if a 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 Ex-change Act. ¨

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

As of June 30, 2017, the aggregate market value of the registrant’s common stock held by non-affiliates of the registrant was $2,171,233,581 based on the closing sale price as reported on the NASDAQ Stock Market.

The number of shares of the registrant’s common stock outstanding as of February 20, 2018 was 195,584,998.

Documents Incorporated by Reference:

Items 10, 11, 12, 13 and 14 of Part III incorporate by reference from the registrant's definitive proxy statement relating to its 2018 annual meeting of shareholders to be filed with the Securities Exchange Commission within 120 days after the close of the registrant's fiscal year.

Blue Buffalo Pet Products, Inc.
Annual Report on Form 10-K

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Statement Regarding Forward-Looking Disclosures

In addition to historical information, this Annual Report on Form 10-K contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which are subject to the "safe harbor" created by those sections. All statements, other than statements of historical facts, included in this Annual Report on Form 10-K are forward-looking statements. In some cases, you can identify these forward-looking statements by the use of words such as "outlook," "believes," "expects," "potential," "continues," "may," "will," "should," "could," "seeks," "predicts," "inter "estimates," "anticipates" or the negative version of these words or other comparable words.

These statements are based on assumptions and assessments made by our management in light of their experience and their perception of historical trends, current conditions, expected future developments and other factors they believe to be appropriate. Any forward-looking statement is subject to various risks and uncertainties. Accordingly, there are, or will be, important factors that could cause actual outcomes or results to differ materially from those indicated in these statements.

Some of the factors that may cause actual results, developments and business decisions to differ materially from those contemplated by such forward-looking statements include, but are not limited to, those described under the section entitled "Risk Factors" in this Annual Report on Form 10-K for the fiscal year ended December 31, 2017 and the following:

- the occurrence of any event, change or other circumstances that could give rise to the termination of the Merger Agreement (as defined under the section entitled "Business" in this Annual Report on Form 10-K) could have a material adverse effect on us and our stock price;
- the inability to consummate the proposed Merger (as defined under the section entitled "Business" in this Annual Report on Form 10-K) or the inability to consummate the Merger in the timeframe or manner currently anticipated, due to the failure to satisfy any of the conditions to completion of the proposed Merger, including that a governmental entity may prohibit, delay or refuse to grant approval for the consummation of the Merger, could have a material adverse effect on us and our stock price;
- risks related to disruption of management's attention from our ongoing business operations due to the proposed Merger;
- the effect of the announcement of the proposed Merger on the Company's relationships with its customers, suppliers, employees and others with whom it has relationships;
- We may not be able to successfully implement our growth strategy on a timely basis or at all, including our launch into select grocery and mass retailers in the FDM channel;
- The growth of our business depends on our ability to accurately predict consumer trends and demand and successfully introduce new products and product line extensions and improve existing products;
- Any damage to our reputation or our brand could have a material adverse effect on our business, financial condition, and results of operations;

- Our growth and business are dependent on trends that may change or not continue, and our historical growth may not be indicative of our future growth;

- There may be decreased spending on pets in a challenging economic climate;

- Our business depends, in part, on the sufficiency and effectiveness of our marketing and trade promotion programs;

- If we are unable to maintain or increase prices, our margins may decrease;

- We are dependent on a relatively limited number of customers for a significant portion of our sales;

- We rely upon a limited number of contract manufacturers to provide a significant portion of our supply of products; and

- We may not be able to successfully complete construction of our new dry food facility, and ramp up operations at such facility or our new treats facility.

We caution you that the risks, uncertainties and other factors referenced above may not contain all of the risks, uncertainties and other factors that are important to you. In addition, we cannot assure you that we will realize the results, benefits or developments that we expect or anticipate or, even if substantially realized, that they will result in the consequences or affect us or our business in the way expected. There can be no assurance that (i) we have correctly measured or identified all of the factors affecting our business or the extent of these factors' likely impact, (ii) the available information with respect to these factors on which such analysis is based is complete or accurate, (iii) such analysis is correct or (iv) our strategy, which is based in part on this analysis, will be successful. All forward-looking statements in this report apply only as of the date of this report or as of the date they were made and we undertake no obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise, except as required by law.

Terms Used in This Annual Report on Form 10-K

We use the terms "we," "us" and the "Company" in this Annual Report on Form 10-K to refer to Blue Buffalo Pet Products, Inc. and its subsidiaries, and references to "Blue Buffalo Pet Products, Inc." and the "Registrant" refer only to Blue Buffalo Pet Products, Inc. exclusive of its subsidiaries. We define our market share based on retail sales rather than volume sold. Our market share based on volume sold is typically lower than our market share based on retail sales as our products are priced at a premium to many of our competitors' products. We calculate the percentage of dogs and cats eating our products based on our share of volume sold in Tracked Channels. We define our market segments as follows:

Wholesome Natural brands achieve their nutritional targets using only natural ingredients (as defined by AAFCO), and may include added vitamins, minerals and other trace nutrients. All Wholesome Natural dry foods have whole meats and/or meat meals, with the type of animal protein clearly identified, as their principal ingredients. Wholesome Natural products (dry foods, wet foods and treats) do not include chicken or poultry by-product meals, which we believe pet parents do not desire. Wholesome Natural products also do not rely on grain proteins, such as corn gluten meal, wheat gluten and soybean meal, as principal sources of protein, as grain proteins have a narrower array of amino acids compared to animal proteins. In addition, these products also do not use corn, wheat, soy or fractionated grains, such as brewer's rice, as sources of starch.

Engineered brands achieve their nutritional targets without fulfilling all the requirements of the Wholesome Natural market segment. They typically do not contain whole meat or meat meal as their principal ingredients and/or they use lower cost proteins (such as chicken by-product meal, corn gluten meal or wheat gluten) and lower-cost starches (such as corn, wheat or fractionated grains). Engineered products may or may not include artificial ingredients or preservatives.

Private Label brands are owned by retailers. While the vast majority of Private Label products fall within the Engineered market segment, some Private Label products fall within the Wholesome Natural market segment based on their ingredients. However, consistent with retail industry practice, market data providers do not identify the specific Private Label SKUs. As a result, Private Label market segment sales are not categorized into either the Wholesome Natural or the Engineered market segment.

Therapeutic (Rx) brands are formulated to support treatment for certain medical conditions and are prescribed by veterinarians. Certain Therapeutic pet foods that claim to diagnose, cure, mitigate or prevent diseases are regulated by the U.S. Food and Drug Administration, or FDA, as animal drugs rather than as pet food, and are subject to FDA pre-market approval. In light of this regulatory process and the distinct veterinary channel, or Vet, for the sale of Therapeutic pet foods, there is no Private Label participation in this market segment.

For purposes of this Annual Report on Form 10-K:

"Tracked Channels" refers to stores and other outlets within channels in which a third-party industry source collects and reports sales data on an ongoing basis with stock keeping unit, or SKU, level detail. In our industry, Tracked Channels include Food-Drug-Mass, or FDM, included in Nielsen's xAOC data, as well as pet stores (including national pet superstores, regional pet store chains and neighborhood pet stores) and veterinary clinics.

"Untracked Channels" refers to stores and other outlets within channels in which no third-party industry source collects and reports sales data on an ongoing basis with SKU level detail. In our industry, Untracked Channels include FDM retailers that do not participate in Nielsen tracking (e.g., Costco and Whole Foods), farm and feed stores, eCommerce retailers, hardware stores and military outlets.

This Annual Report on Form 10-K includes our trademarks, trade names and service marks, such as "Blue Buffalo," "LifeSource Bits," "Life Protection Formula," "BLUE Basics," "BLUE Freedom," "BLUE Wilderness," and "BLUE Natural Veterinary Diet," as well as the BLUE shield logo, the Blue Buffalo figure logo and the tag line "Love them like family. Feed them like family." which are protected under applicable intellectual property laws and are our property. This Annual Report on Form 10-K also contains trademarks, trade names and service marks of other companies, which are the property of their respective owners. Solely for convenience, trademarks and trade names referred to in this Annual Report on Form 10-K may appear without the ®, TM or SM symbols, but such references are not intended to indicate, in any way, that we will not assert, to the fullest extent under applicable law, our rights or the right of the applicable licensor to these trademarks, trade names and service marks. We do not intend our use or display of other parties' trademarks, trade names or service marks to imply, and such use or display should not be construed to imply, a relationship with, or endorsement or sponsorship of us by, these other parties.

Social Media

We may use our website (www.bluebuffalo.com) and our corporate Facebook page (https://www.facebook.com/BlueBuffalo) as channels of distribution of Company information. The information we post through these channels may be deemed material. Accordingly, investors should monitor these channels, in addition to following our press releases, Securities and Exchange Commission ("SEC") filings and public conference calls and webcasts. The contents of our website and social media channel are not, however, a part of this report.

PART I

ITEM 1. BUSINESS

Proposed Merger with General Mills, Inc.

On February 22, 2018, Blue Buffalo Pet Products, Inc., General Mills, Inc., a Delaware corporation ("GMI"), and Bravo Merger Corp., a Delaware corporation and wholly-owned subsidiary of GMI ("Merger Sub"), entered into an Agreement and Plan of Merger (the "Merger Agreement"), pursuant to which, on the terms and subject to the conditions set forth in the Merger Agreement, GMI agreed to acquire the Company for $40.00 per common share, in cash.

On the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will merge with and into the Registrant (the "Merger"), with the Registrant continuing as the surviving company and as a wholly-owned subsidiary of GMI, and our common stock will be delisted from the NASDAQ Stock Market. At the effective time of the Merger, each share of our common stock (other than shares of the Company's common stock held by GMI, Merger Sub or any other wholly-owned subsidiary of GMI, shares owned by the Company (including shares held in treasury) or any of its wholly-owned subsidiaries, and shares owned by stockholders who have properly exercised and perfected appraisal rights under Delaware law) will be converted into the right to receive $40.00 in cash per share.

The boards of directors of each of GMI and the Registrant have approved the Merger Agreement and holders of more than 50% of the Registrant's outstanding shares have approved the transaction. While no other approval of the Registrant's Board of Directors or shareholders is required to complete the transaction, the closing of the Merger is subject to certain regulatory approvals and other customary closing conditions.

There is no assurance that the Merger will occur. See "Risk Factors-Risks Related to the Pending Merger" in "Part I-Item 1A. Risk Factors."

Overview

We are one of the fastest growing major pet food companies in the United States, selling dog and cat food made with whole meats, fruits and vegetables, and other high-quality, natural ingredients. BLUE is a billion dollar brand and is the #1 brand in the Wholesome Natural market segment. We currently have approximately 7% share of the U.S. pet food market and feed only 3% of the 184 million pets in the United States. With a proven new user acquisition strategy, we are committed to converting more pet parents into True Blue Believers and continuing to increase our share of the attractive $28 billion U.S. pet food market.

We believe we have built an exceptional company with a breakthrough brand and an innovative business model, backed by our mission and our belief in a large unmet consumer demand for pet food with high-quality, natural ingredients.

Our History

Today, Blue Buffalo Pet Products, Inc. ("BBPP", and together with its subsidiaries, the "Company," "we," "us," "its," and "ou conducts its business exclusively through its wholly-owned operating subsidiary, Blue Buffalo Company, Ltd. (“Blue”) and its subsidiaries. Blue was originally formed in August 2002 as a limited liability company under the name The Blue Buffalo Company, LLC. In December 2006, Blue converted into a corporation under the name Blue Buffalo Company, Ltd. In July 2012, we undertook a corporate reorganization and exchanged the stock of Blue for the stock of BBPP, a newly formed Delaware corporation. As part of the corporate reorganization, BBPP established another Delaware corporation, Blue Pet Products, Inc., which then became the sole shareholder of Blue.

Our Industry

Pet food is one of the largest consumer packaged goods ("CPG") categories in the United States. We estimate that the U.S. pet food industry had approximately $28 billion in retail sales in 2017. According to Euromonitor, the pet food industry had approximately $51 billion in additional retail sales outside the United States in 2017, bringing the total size of the global pet food industry to approximately $79 billion.

U.S. pet food retail sales grew 57% between 2007 and 2017, which represents a compound annual growth rate ("CAGR") of 5%, based on data from Euromonitor. The industry growth over this period has been fueled by the “humanization” of pets, as pets are increasingly regarded as family members. This humanization trend has led pet parents to increasingly evaluate pet foods in the same way they scrutinize their own food choices. As more pet parents seek better, more wholesome options for themselves, they also seek these types of options for their pets. As a result, a significant number of pet parents have demonstrated a willingness to pay a premium for pet food that they believe will enhance the well-being of their pets. The higher demand for natural food products and more specialized formulas for different life-stages, breed sizes, special needs and diet types has fueled premiumization in the industry, leading to the faster growth of products with higher revenue per pound. This premiumization trend has impacted all market segments and product types in the pet food industry.

Our Brand and Products

We have the broadest portfolio of products of any natural pet food brand in the United States. Our tailored product offerings enable our pet parents to satisfy their pet’s specific dietary, lifestyle and life-stage needs, offering them no-compromise product solutions. We also have a broad product portfolio across different product types, diet types, breed sizes for dogs, lifestages, flavors, product functions and textures and cuts for wet foods.

We operate our business on the basis of one reportable operating segment. For more information on our operating segment reporting, as well as financial information about geographic areas, see Note 2 - "Basis of Presentation" to our consolidated financial statements under Item 8. "Financial Statements and Supplementary Data."

Our product portfolio enjoys a strong base of existing products, combined with a strong track record of significant and incremental new product introductions. We have a multi-year product development funnel we use to plan and manage our product development engine. Once a concept passes our screening criteria, we believe we can bring new products to the market significantly faster than our major competitors as a result of our singular focus on the Wholesome Natural market segment and our integrated in-house marketing, research and development and product development capabilities. Our retail partners also look to us to drive innovation and enable us to rapidly introduce new products into the marketplace.

We have five product lines under our master BLUE brand. Each of our product lines has a different nutritional philosophy and distinct personality. We continue to deepen each product line with new products, expand each product line's shelf presence and support each product line with advertising:

BLUE Life Protection Formula – introduced in 2003, this is our original and largest product line with the broadest flavor, functional and breed-specific variety. Products under this line may not refer to "BLUE Life Protection Formula" explicitly on their packaging as we group all food products that are not specifically designated as one of our other lines below;

BLUE Wilderness – introduced in 2007, this is our high-meat, high-protein, grain-free ancestral feeding line and our second largest product line;

BLUE Basics – introduced in 2010, this is our line of limited ingredient diet products for pets with food sensitivities;

BLUE Freedom – introduced in 2012, this is our grain-free line that is a cousin of the original BLUE Life Protection Formula line; and

BLUE Natural Veterinary Diet – introduced in 2015, this is our line of Therapeutic diets for pets, offered exclusively through veterinarians.

Sales and Distribution Channels

We sell our products in the United States, Canada, Japan, and Mexico. The majority of our net sales are in the United States. In 2017, approximately 4% of our net sales were outside the United States.

BLUE products are sold in specialty channels, including national pet superstore chains, regional pet store chains, neighborhood pet stores, farm and feed stores, eCommerce retailers, military outlets, hardware stores, and veterinary clinics and hospitals, as well as in a number of select grocery and mass retailers in the FDM channel in the United States. Our sales in the veterinary channel are currently minimal.

Historically, we only sold our products directly to retailers in the specialty channels and through distributors that focus on the specialty channels. On August 1, 2017, we announced the introduction of our BLUE Life Protection Formula product line to a limited number of select grocery and mass retailers in the FDM channel in the United States. Throughout 2017 we expanded, and we expect to continue to expand, our distribution in the FDM channel. In 2017, management believes specialty channels accounted for 48% of U.S. pet food sales, with FDM channels accounting for the other 52%. Specialty channels include a diverse set of retailers with over 20,000 stores (which includes national pet superstore chains (i.e., PetSmart and Petco, including their websites), regional pet store chains (e.g., Pet Supplies Plus, Pet Supermarket, Petsense and Pet Valu), neighborhood pet stores, farm and feed stores (e.g., Tractor Supply Company and Mid-States), eCommerce retailers (e.g., Amazon, Chewy (a subsidiary of PetSmart) and Petflow), military outlets, hardware stores and 25,000 veterinary clinics. We historically chose to sell BLUE exclusively in the specialty channels as we believe these channels provided an optimal environment for us to interact with and educate pet parents and helped to position BLUE as a premium brand, and because retailers in these channels dedicate more shelf space to pet food, which grants consumers access to a broader range of our products. In 2017 we determined that partnering with leading grocery and mass retailers in the FDM channel was the next step in the natural evolution of our go-to-market model that will allow us to reach more pet parents and feed more pets. Pet food sales in specialty channels have grown faster than pet food sales in the FDM channel for the past 20 years as a result of the expansion of the channel and its pet focused environment and superior product selection. While we expect growth of pet food sales in the specialty channels to continue to outpace growth in FDM due to rapid growth in eCommerce retailers, the gap between the channels is narrowing. We have experienced significant growth in our net sales to eCommerce retailers, and these sales have continued to grow faster than our net sales to national pet superstores. In fact, our net sales to national pet superstores declined in 2017 primarily due to reduced traffic trends at such stores.

Whether we sell our products directly to retailers or through distributors primarily depends on the size of the account and whether the account has account-operated distribution centers for its own outlets. We review accounts on a regular basis and may re-designate them as a direct or distributor account depending on our cost-to-serve them, trends in their business and channel and changes in their distribution capabilities. The majority of our products are sold directly to retailers. Our direct accounts include large national and regional chains with their own distribution capability, such as PetSmart, Petco, Tractor Supply Company, Pet Supermarket, Target, Kroger, Meijer, and Publix, as well as larger eCommerce retailers. In 2017, 59% of our net sales were generated from sales to PetSmart (including Chewy.com as of an estimated acquisition date of June 1, 2017) and Petco. We also experienced significant growth in our net sales to eCommerce retailers in 2017 and expect those sales to continue to increase both in absolute terms and as a percentage of net sales. If we were to lose any of these key customers, our business, financial condition and results of operations would be materially adversely affected.

Most of our retailers in the regional and neighborhood specialty channel and the farm and feed store channel are served through our distributors. We have multiple distributors in most of our geographic areas. These distributors specialize in, and typically carry a wide assortment, of pet products. We believe we are one of their largest brands. Our distributors provide mainly logistics services and limited in-field sales support, with sales and account acquisition being driven primarily by us and through in-bound interest directly from retailers. From time to time, we offer certain promotional incentives to distributors to help them build our business.

Our sales teams are organized by the type of retail accounts they sell to in order to optimize sales strategies and tools. Our National Accounts Team services large national chains, our Regional Accounts Team services regional pet store chains, neighborhood pet stores and farm and feed stores, our eCommerce Team services retail accounts, and our FDM Team serves our grocery and mass accounts with the support of a retail broker. These teams share a sales operations team, which assists them with planning, fulfillment, sales and market analytics and pet parent relations. We also have a Regional Accounts field sales force, which works closely with distributor representatives to acquire new accounts and improve our position at our existing accounts. We believe we have one of the largest sales forces dedicated to the regional and neighborhood pet and farm and feed channels.

In addition, we deploy our Pet Detectives, part-time pet-passionate team members, to help us fulfill our mission to educate fellow pet parents about pet nutrition. Pet Detectives interact with pet parents one-on-one as they shop for pet food in our retail partners nationwide, as well as in Canada, Mexico and Japan. Our Pet Detective program serves as an educational marketing and sales platform as it is a resource for both pet parents already feeding their pets BLUE and pet parents currently feeding their pets other pet food brands. The Pet Detectives allow us to engage pet parents with our brand story, our mission and our shared love for pets in an authentic manner.

## Manufacturing Network

Our products, including those sold outside of the U.S., are currently manufactured through a hybrid network of owned and contracted manufacturing facilities and distributed from owned and contracted distribution centers. We currently operate a dry food production facility in Joplin, Missouri (the "Joplin Dry Food Facility"), which provided us with approximately 55% of our dry food production needs in 2017. The Joplin Dry Food Facility and our dry food manufacturing facility in Richmond, Indiana (the "Heartland Richmond Facility,") which is expected to be completed in the second half of 2018, are expected to initially provide us with approximately 60% of our dry food production needs and expand up to approximately 85% of our dry food production needs over the next several years. In addition, we recently commenced operations at our first treats facility, which is adjacent to our existing facility in Joplin (the "Joplin Treats Facility", together with the Joplin Dry Food Facility, "The Heartland Joplin Facilities", and collectively with the Heartland Richmond Facility, our "Heartland Facilities").

Our business arrangements with our third party contracted manufacturing facilities vary by contract manufacturing partner. With our largest, core contract manufacturers, we typically have multi-year contracts in place that guarantee an amount of monthly production capacity and annual or multi-year fixed tolling charges, while assuring the contract manufacturer a minimum order volume on a monthly or quarterly basis. This arrangement allows the contract manufacturer to achieve efficiencies in managing its facility, while assuring us of the capacity we need to meet our growing volume requirements. With contract manufacturers with whom we do not have multi-year contracts, we typically have commitments of capacity based on a rolling three months forecast. We work closely with each of our manufacturing partners and provide them with a rolling production forecast, which enables them to better capacity plan and sequence their production efficiently.

Our natural ingredients are sourced primarily from suppliers in the United States. Our procurement team is responsible for assuring ingredient supply and pricing to meet forecasted demand. We contract and ensure availability directly with suppliers for most of the major ingredients in our dry foods, whether manufactured by us at our Heartland facilities or by our contract manufacturers. All supplier facilities then go through our rigorous quality qualification process based on our ingredient specifications before any ingredients are shipped. The manufacturing facilities in our manufacturing network then purchase these ingredients from suppliers approved by us on the terms we negotiated. This has allowed us to consolidate ingredient sourcing across our manufacturing network in order to negotiate favorable pricing and consistency on ingredients for dry foods, which make up the majority of our product portfolio. For wet foods and treats, our contract manufacturers negotiate directly with suppliers approved by us and purchase ingredients directly based on our specifications. We have detailed specifications for raw materials used in all of our products. In all cases, we purchase finished products from the contract manufacturers predominantly on a cost-plus basis. We pay our contract manufacturers on a dollar-per-pound basis for dry foods and dollar-per-unit basis for wet foods and treats. These arrangements allow us to control the cost structure of our products. At our Heartland Facilities, we are responsible for the direct procurement of all ingredients and packaging for products we manufacture in-house.

## Research and Development

Our research and development and product development teams work together to develop natural products that we, as pet parents, would want to feed our pets. Our focus on natural ingredients is a core advantage as we continue to develop and build upon our expertise. The formulations and processes required for the manufacture of Wholesome Natural pet foods often are different from those of Engineered pet foods.

For example, developing and managing the shelf life of products is more difficult when using only natural preservatives. In addition, wheat, which is a “natural” ingredient, is a low-cost but effective food binder that is commonly used in the pet food industry. Since we do not use wheat in any of our products, we have developed know-how and expertise in the use of ingredients other than wheat to act as food binders. Our research and development team, staffed with animal nutritionists with PhDs and food scientists, works on new technologies, formulations and testing. Our product development team provides consumer and market insight, as well as project management leadership. Working together with our in-house advertising and marketing agency, the two teams develop and launch new products and improve our existing products. We also work with external technical experts and suppliers to help us stay at the forefront of technological developments and advancements. In 2017, 2016 and 2015, our total research and development expenses were $11.3 million, $9.8 million and $9.5 million, respectively. These expenses include personnel costs, testing costs and expenses related to outside services.

Competitive Landscape

The pet food industry is highly competitive. We compete on the basis of product quality and palatability, brand awareness and loyalty, product variety and ingredients, interesting product names, product packaging and package design, shelf space (both online and in-store), reputation, price and promotional efforts. Our main competitors are large CPG companies with long histories and well-recognized brands. Companies with major pet food businesses include Nestlé, Mars, the J.M. Smucker Company (owner of Big Heart Pet Brands, formerly known as Del Monte) and Colgate-Palmolive.

The pet food industry is highly fragmented at the brand level, with over 100 brands with retail sales exceeding $10 million in 2017. Our major competitors typically follow a brand portfolio approach with each brand often having distinct positioning by species and/or product type. Unlike most of our competitors, we have a master BLUE brand with a strong identity on the top and individual product lines underneath.

Over the last decade, all of our major competitors and many independent companies have also entered or have attempted to benefit from the fast-growing Wholesome Natural market segment through new brand introductions, brand extensions and/or acquisitions. These attempts have included entries directly into the Wholesome Natural market segment, as well as launching brands and products that have some but not all of the Wholesome Natural market segment’s characteristics. Most of the pet food brands we compete with in the Wholesome Natural market segment, such as the Wellness and Taste of the Wild brands, are not owned by major pet food companies but are instead owned by other pet food companies such as WellPet and Diamond Pet Foods, respectively. In 2017, we had approximately one-third market share in the Wholesome Natural market segment and were over four times the size of the next largest Wholesome Natural brand.

In 2017, the Therapeutic market segment had retail sales of over $1.7 billion in the United States and continued to grow at a higher rate than the overall pet food market. We believe there are significant barriers-to-entry to the Therapeutic market segment as it requires significant research and development expertise and investment, the ability to reach veterinary clinics through a separate sales force and distribution network, and compliance with specific FDA regulatory requirements and processes. After investing significant time and resources, we entered this market segment in 2015 with differentiated natural Therapeutic pet food products. Due to the significant barriers-to-entry, other than us, currently only three major pet food companies participate in the Therapeutic market segment in the United States.

## Seasonality

Our business generally is not subject to seasonal fluctuations to any significant extent.

## Our Organization: “The Herd”

Our company culture is an integral part of our strategy and one of our founding objectives is being a great place to work. We have a strong and dedicated team of employees we refer to as “the Herd,” where each one of us is a “Buff.” Our company culture is built on entrepreneurship, collaboration, a commitment to Blue Buffalo’s mission, a competitive spirit and a friendly, casual work environment. As of December 31, 2017, we employed approximately 1,800 Buffs, including full-time and part-time Buffs, none of whom was represented by a labor union. We believe we have a good relationship with our team members and that our company culture is a key competitive advantage and a strong contributor to our success.

## Our Trademarks and Other Intellectual Property

We believe that our intellectual property has substantial value and has contributed significantly to the success of our business. Our primary trademarks include “Blue Buffalo,” “LifeSource Bits,” “Life Protection Formula,” “BLUE Basics,” “BLUE Freedom,” “BLUE Wilderness,” “BLUE Natural Veterinary Diet,” the BLUE shield logo and the Blue Buffalo figure logo, each of which is registered or has a trademark registration pending with the U.S. Patent and Trademark Office. The Blue shield design logo is also registered or has a trademark registration pending in Canada, Mexico, Japan, Europe, Russia, China, Australia and approximately 28 other countries or registries. We also have numerous other trademark registrations and pending applications for product names and tag lines that are essential to our branding. Our trademarks are valuable assets that reinforce the distinctiveness of our brand and our consumers’ favorable perception of our products. The current registrations of these trademarks in the United States and foreign countries are effective for varying periods of time and may be renewed periodically, provided that we, as the registered owner, or our licensees where applicable, comply with all applicable renewal requirements including, where necessary, the continued use of the trademarks in connection with similar goods. In addition to trademark protection, we own numerous URL designations, including www.bluebuffalo.com and www.bluesbuddies.com. We also rely on and carefully protect unpatented proprietary expertise, recipes and formulations, continuing innovation and other trade secrets to develop and maintain our competitive position.

## Government Regulation

Blue Buffalo, along with its contract manufacturers, distributors and ingredients and packaging suppliers, is subject to extensive regulation in the United States by federal, state and local government authorities including the U.S. Food and Drug Administration (the "FDA"), the U.S. Department of Agriculture, U.S. Customs and Border Protection and the U.S. Environmental Protection Agency, as well as state and local agencies, with respect to registrations, production processes, product attributes, packaging, labeling, storage and distribution. We believe that we are in material compliance with all regulations applicable to our business.

Pet Food-Related Regulation

The FDA's Center for Veterinary Medicine, or CVM, regulates animal feed, including pet food, under the Federal Food, Drug, and Cosmetic Act, or FFDCA, and its implementing regulations. Although pet foods are not required to obtain premarket approval from the FDA, any substance that is added to or is expected to become a component of a pet food must be used in accordance with a food additive regulation, unless it is generally recognized as safe, or GRAS, under the conditions of its intended use. A food additive regulation may be obtained through the submission of a food additive petition to the FDA demonstrating that a food additive is safe for its intended use and has utility. Use of a food ingredient that is neither GRAS nor an approved food additive may cause a food to be adulterated, in which case the food may not be legally marketed in the United States.

The labeling of pet foods is regulated by both the FDA and some state regulatory authorities. FDA regulations require proper identification of the product, a net quantity statement, a statement of the name and place of business of the manufacturer or distributor, and proper listing of all the ingredients in order of predominance by weight. The FDA also considers certain specific claims on pet food labels to be medical claims and therefore subject to prior review and approval by the FDA. These include claims such as "hairball control" and "urinary tract health." We currently produce pet food products, such as cat food with hairball management claims, which undergo FDA premarket review. In addition, the Food and Drug Administration Amendments Act of 2007 requires the FDA to establish ingredient standards and definitions for pet food, processing standards for pet food, and updated labeling standards for pet food that include nutritional and ingredient information. The FDA is currently working to implement these requirements.

We currently produce products, such as those in our BLUE Natural Veterinary Diet line, which may provide all or most of the nutrients in support of an animal's total daily nutrient needs but are also labeled and marketed with claims that may suggest that they are intended to treat or prevent disease, thereby potentially meeting the statutory definitions of both a food and a drug. In the past, the FDA has generally exercised discretion with regard to enforcement of the regulatory requirements applicable to animal drugs in the context of dog and cat foods (i) that provided nutrients in support of the animal's total required daily nutrient needs, (ii) that were distributed only through licensed veterinarians, and (iii) with respect to which manufacturers restricted labeling claims. However, noting an increase in the number of dog and cat foods labeled as being intended for use in the diagnosis, cure, mitigation, treatment or prevention of disease, and noting that animal health may suffer when such products are not subject to pre-market FDA approval and are provided in the absence of a valid veterinarian-client-patient relationship, the FDA recently issued guidance containing a list of specific factors it will consider in determining whether to initiate enforcement action against products that satisfy the definitions of both an animal food and an animal drug, but which do not comply with the regulatory requirements applicable to animal drugs. These include, among other things, whether the product is only made available through or under the direction of a veterinarian and does not present a known safety risk when used as labeled. While we believe that we market our products in compliance with the policy articulated in the FDA's guidance and in other claim-specific guidance, the FDA may disagree or may classify some of our products differently than we do, and may impose more stringent regulations applicable to animal drugs, such as requirements for pre-market approval and compliance with Good Manufacturing Practices, or GMPs, for the manufacturing of pharmaceutical products. In addition, we may produce more products that may be subject to FDA pre-market review, including new products we introduce to the Therapeutic market segment.

Under Section 423 of the FFDCA, the FDA may require the recall of an animal feed product if there is a reasonable probability that the product is adulterated or misbranded and the use of or exposure to the product will cause serious adverse health consequences or death. In addition, pet food manufacturers may voluntarily recall or withdraw their products from the market. We have in the past issued limited voluntary recalls of products that we considered did not meet our standards, whether for palatability, appearance or otherwise, in order to protect our brand and reputation.
Most states also enforce their own labeling regulations, many of which are based on model definitions and guidelines developed by AAFCO. AAFCO is a voluntary, non-governmental membership association of local, state and federal agencies that are charged with regulation of the sale and distribution of animal feed, including pet foods. The degree of oversight of the implementation of these regulations varies by state, but typically includes a state review and approval of each product label as a condition of sale in that state.
Most states require that pet foods distributed in the state be registered or licensed with the appropriate state regulatory agency. In addition, most facilities that manufacture, process, pack, or hold foods, including pet foods, must register with the FDA and must renew their registration every two years. This includes most foreign facilities, as well as domestic facilities. Registration must occur before the facility begins its pet food manufacturing, processing, packing or holding operations.
In 2011, the Food Safety Modernization Act, or FSMA, was enacted. The FSMA mandates, among other things, that the FDA adopt preventative controls to be implemented by pet food facilities in order to minimize or prevent hazards to food safety. Under the FSMA, the FDA finalized the Current Good Manufacturing Practice, Hazard Analysis, and Risk-Based Preventive Controls for Food for Animals, or CGMP, on September 17, 2015. The final rule has staggered compliance dates based on the business size. There are two components of the final rule with different compliance dates including CGMP requirements and the Preventive Controls. Blue Buffalo was required to be in compliance with the CGMP by September 2016 and was required to be in compliance with the Preventive Controls by September 2017. The FDA also finalized the Foreign Supplier Verification Program (FSVP) on November 27, 2015, with a compliance date of July 2017. The third relevant regulation is the Sanitary Transportation of Human and Animal Food, which had a compliance date of April 6, 2017. We believe that we are in compliance with those regulations in effect that are relevant to our business.
We also are subject to the laws of Canada, Mexico and Japan, as well as provincial and local regulations, with regard to products exported to those jurisdictions. In Canada, we are subject to regulation and oversight by the Canadian Food Inspection Agency and other provincial and local agencies. In Mexico, we are subject to regulation and oversight by the Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food, or SAGARPA, the National Service of Health, Food Safety and Quality, or SENASICA, which is an administrative body of SAGARPA and other state and local agencies. In Japan, we are subject to regulation and oversight by the Ministry of Agriculture, Forestry and Fisheries, the Ministry of the Environment and other local agencies. As we enter into new foreign markets, we will be subject to similar laws and regulation, and oversight by foreign governmental and regulatory agencies, in those jurisdictions.
Employee and Occupational Safety Regulation

We are subject to certain state and federal employee safety and employment practices regulations, including regulations issued pursuant to the U.S. Occupational Safety and Health Act, and regulations governing prohibited workplace discriminatory practices and conditions. These regulations require us to comply with certain manufacturing safety standards, including protecting our employees from accidents, providing our employees with a safe and non-hostile work environment and being an equal opportunity employer.

Environmental Regulation

As a result of our pet food manufacturing and packaging activities, we at our Heartland Facilities, and we and our contract manufacturers at their facilities, are subject to federal, state and local environmental laws and regulations. These govern, among other things, air emissions, wastewater and stormwater discharges, and the treatment, handling and storage and disposal of materials and wastes.

Manufacturing Related Regulation

In connection with our operations at our Heartland Facilities, we are subject to the jurisdiction of the U.S. Department of Agriculture and certain state and local agencies which may inspect the facility and regulate health and safety issues. Operation at the Heartland Joplin Facilities also subjects us to regulation by the Missouri Department of Natural Resources and local planning, zoning and health agencies and upcoming operations at the Heartland Richmond Facility will subject us to regulation by the Indiana Department of Environmental Management. The Heartland Facilities must also be registered with the FDA, and will need to comply with the applicable requirements established under the FDA’s final rules regarding Manufacturing Practice, Hazard Analysis, and Risk-Based Preventative Controls for Food for Animals.

Available Information

Our Internet address is www.bluebuffalo.com. We are not including the information contained on our website as part of, or incorporating it by reference into, this Annual Report on Form 10-K. On our website, we make available, free of charge, our Annual Reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements, director and officer reports on Forms 3, 4, and 5, and any amendments to these reports, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (“SEC”). Our SEC reports can be accessed through the investor relations section of our website. The information found on our website is not part of this or any other report we file with or furnish to the SEC. We also make available on our website our Code of Ethics and Business Conduct, our Corporate Governance Principles, and the charters for the Compensation and Audit Committees of the Board of Directors. Our SEC filings are also available for reading and copying at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site, www.sec.gov, containing reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

ITEM 1A. RISK FACTORS

You should carefully consider each of the following risk factors as well as the other information contained in this Annual Report on Form 10-K in evaluating our Company and our business. Additional risks and uncertainties not presently known to us or that we currently consider immaterial may also impact our business operations. If any of the following risks actually occur, our business, results of operations and financial condition may be materially adversely affected.

Risks Related to the Pending Merger

The pending Merger with GMI is contingent upon the satisfaction of a number of conditions, may require significant time and attention of our management, and may have a material adverse effect on us if it is not completed.

On February 22, 2018, the Registrant entered into the Merger Agreement, pursuant to which, on the terms and subject to the conditions set forth in the Merger Agreement, GMI will purchase our common stock for cash consideration. The Merger Agreement generally requires us to operate our business in the ordinary course pending consummation of the proposed Merger and restricts us, without GMI’s consent, from taking certain specified actions until the Merger is completed. These restrictions may affect our ability to execute our business strategies and attain our financial and other goals and may impact our financial condition, results of operations and cash flows. In addition, the pursuit of the Merger and the preparation for the integration of our business with GMI may place a significant burden on management and internal resources. The diversion of management’s attention away from day-to-day business concerns could adversely affect our financial results.

We currently anticipate that we will close the Merger during the second quarter of 2018, but we cannot be certain when or if the conditions for the Merger will be satisfied or waived. The Merger cannot be completed until the conditions are satisfied or waived, including the receipt of required antitrust and other regulatory approvals and other customary closing conditions. Satisfying the conditions to the closing of the Merger may take longer than we expect. In the event that the Merger is not completed for any reason, the holders of our common stock will not receive any payment for their shares of our common stock in connection with the proposed Merger. Instead, we will remain an independent public company and holders of our common stock will continue to own their shares of our common stock. If the Merger is not completed for any reason, the price of our common stock may decline to the extent that the current market price may reflect an assumption that the Merger will be consummated at the per share merger consideration of $40.00 in cash specified in the Merger Agreement. Investor confidence also could decline.

Whether or not we complete the Merger, our ongoing businesses may be adversely affected and we may be subject to certain risks and consequences as a result of pursuing the Merger, including, among others, the following:

- execution of the proposed Merger will require significant time and attention from management, which may distract them from the operation of our business and the execution of other initiatives that may have been beneficial to us;

- our employees may be distracted due to uncertainty about their future roles with the Company pending the completion of the Merger;
- parties with which we have business relationships may experience uncertainty as to the future of such relationships and may delay or defer certain business decisions, seek alternative relationships with third parties or alter their present business relationships with us;
- we could be subject to litigation related to the proposed Merger, which could result in significant costs and expenses;
- we will be required to pay significant costs and expenses relating to the Merger, such as legal, accounting and other professional fees, whether or not the Merger is completed;
- we may have to forgo other opportunities in favor of the Merger instead of pursuing such other opportunities that could be beneficial to the Company; and
- we may experience negative reactions from the financial markets, particularly if we fail to complete the Merger.

In addition to the foregoing, the amount of the per share merger consideration to be paid in cash pursuant to the Merger Agreement is fixed and will not be increased for changes in our business, assets, liabilities, prospects, outlook, financial condition or results of operation or in the event of any change in the market price of, analyst estimates of, or projections relating to, our common stock.

Risks Related to Our Business and Industry

We may not be able to successfully implement our growth strategy on a timely basis or at all.

Our future success depends, in large part, on our ability to implement our growth strategy of expanding distribution and improving placement of our products in the stores of our retail partners, attracting new consumers to our brand, and introducing new products and product line extensions and expanding into new markets. Our ability to implement this growth strategy depends, among other things, on our ability to:

- enter into distribution and other strategic arrangements with retailers and other potential distributors of our products;
- effectively compete in specialty and FDM channels;
- secure shelf space in the stores and websites of our retail partners;
- increase our brand recognition by effectively implementing our marketing strategy and advertising initiatives;
- expand and maintain brand loyalty;
- develop new products and product line extensions that appeal to consumers;

- maintain and, to the extent necessary, improve our high standards for product quality, safety and integrity;
- maintain sources for the required supply of quality raw ingredients to meet our growing demand;
- continue successfully to expand our internal manufacturing capabilities, including completing construction of our new dry food manufacturing facility and ramping up production of that facility;
- successfully operate our Heartland Facilities;
- further expand in both new and existing international markets;
- identify and successfully enter, and market our products in, new geographic markets and market segments; and
- continue to educate the veterinarian community about our line of veterinary exclusive therapeutic products and generate recommendations from veterinarians for our current portfolio of Wholesome Natural products.

We may not be able to successfully implement our growth strategy and may need to change our strategy. If we fail to implement our growth strategy or if we invest resources in a growth strategy that ultimately proves unsuccessful, our business, financial condition and results of operations may be materially adversely affected.

The growth of our business depends on our ability to predict accurately consumer trends and demand and successfully introduce new products and product line extensions, improve existing products and offer our products at attractive price points.

Our growth depends, in part, on our ability successfully to introduce new products and product line extensions and improve and reposition our existing products to meet the requirements of pet parents and the dietary needs of their pets. This, in turn, depends on our ability to predict and respond to evolving consumer trends, demands and preferences. The development and introduction of innovative new products and product line extensions involve considerable costs. In addition, it may be difficult to establish new supplier relationships and determine appropriate product selection when developing a new product or product line extension. Any new product or product line extension may not generate sufficient customer interest and sales to become a profitable product or to cover the costs of its development and promotion and may reduce our operating income. In addition, any such unsuccessful effort may adversely affect our brand. If we are not able to anticipate, identify or develop and market products that respond to changes in requirements and preferences of pet parents and their pets or if our new product introductions or repositioned products fail to gain consumer acceptance, we may not grow our business as anticipated, our sales may decline and our business, financial condition and results of operations may be materially adversely affected. If our retail prices were to increase due to a price increase by us or by price increases or lower promotions by our retailer partners, the consumer demand for our products and hence our sales may decline.

Any damage to our reputation or our brand could have a material adverse effect on our business, financial condition, and results of operations.

Maintaining our strong reputation with consumers, our retail partners and our suppliers is critical to our success. Our brand may suffer if our marketing plans or product initiatives are not successful. The importance of our brand may increase if competitors offer more products with formulations similar to ours. Price competition between retailers may drive our retail prices down and may adversely impact our brand equity and reputation among consumers and/or retailers. Further, our brand may be negatively impacted due to real or perceived quality issues or if consumers perceive us as being untruthful in our marketing and advertising, even if such perceptions are not accurate. Product contamination, the failure to maintain high standards for product quality, safety and integrity, including raw materials and ingredients obtained from suppliers, or allegations of product quality issues, mislabeling or contamination, even if untrue or caused by our third-party contract manufacturers or raw material suppliers, may reduce demand for our products or cause production and delivery disruptions. We maintain guidelines and procedures to ensure the quality, safety and integrity of our products. However, we may be unable to detect or prevent product and/or ingredient quality issues, mislabeling or contamination, particularly in instances of fraud or attempts to cover up or obscure deviations from our guidelines and procedures. If any of our products become unfit for consumption, cause injury or are mislabeled, we may have to engage in a product recall and/or be subject to liability. Damage to our reputation or our brand or loss of consumer confidence in our products for any of these or other reasons could result in decreased demand for our products and our business, financial condition and results of operations may be materially adversely affected.

Our growth and business are dependent on trends that may change or not continue, and our historical growth may not be indicative of our future growth.

The growth of the overall pet food industry depends primarily on the continuance of current trends in humanization of pets and premiumization of pet foods as well as on general economic conditions, the size of the pet population and average dog size. The growth of the Wholesome Natural market segment and our business, in particular, depends on the continuance of such humanization and premiumization trends and health and wellness trends. We also benefit from growth rates in the channels in which we participate, such as pet superstores, food and mass stores, farm and feed stores and eCommerce. These trends may not continue or may change. For example, pet superstores have recently experienced reduced foot traffic and reduced sales. We believe that these trends may continue, which would result in a decline in our growth rate unless offset by growth in other channels and accounts. In addition, in the event of a decline in the overall number or average size of pets, a change in the humanization, premiumization or health and wellness trends or during challenging economic times, we may be unable to persuade our customers and consumers to purchase our branded products instead of lower-priced products, and our business, financial condition and results of operations may be materially adversely affected and our growth rate may slow or stop. In addition, while we expect that our net sales will continue to increase, we believe that our growth rate will decline in the future as our scale increases.

There may be decreased spending on pets in a challenging economic climate.

The United States and other countries have experienced, and may in the future experience, challenging economic conditions. Our business, financial condition and results of operations may be materially adversely affected by a challenging economic climate, including adverse changes in interest rates, volatile commodity markets and inflation, contraction in the availability of credit in the market and reductions in consumer spending. In addition, a slow-down in the general economy or a shift in consumer preferences for economic reasons or otherwise to regional, local or Private Label products or other less expensive products may result in reduced demand for our products which may affect our profitability. The keeping of pets and the purchase of pet-related products may constitute discretionary spending for some of our consumers and any material decline in the amount of consumer discretionary spending may reduce overall levels of pet ownership or spending on pets. As a result, a challenging economic climate may cause a decline in demand for our products which could be disproportionate as compared to competing pet food brands since our products command a price premium. In addition, we cannot predict how current or worsening economic conditions will affect our retail partners, suppliers and distributors. If economic conditions result in decreased spending on pets and have a negative impact on our retail partners, suppliers or distributors, our business, financial condition and results of operations may be materially adversely affected.

Our business depends, in part, on the sufficiency and effectiveness of our marketing and trade promotion programs.

Due to the highly competitive nature of our industry, we must effectively and efficiently promote and market our products through television, internet and print advertisements as well as trade promotions and incentives to sustain our competitive position in our market. Marketing investments may be costly. In addition, we may, from time to time, change our marketing strategies and spending, including the timing or nature of our trade promotions and incentives. We may also change our marketing strategies and spending in response to actions by our competitors and other pet food companies. The sufficiency and effectiveness of our marketing and trade promotions and incentives are important to our ability to retain and/or improve our market share and margins. If our marketing and trade promotions and incentives are not successful or if we fail to implement sufficient and effective marketing and trade promotions and incentives or adequately respond to changes in our competitors' marketing strategies, our business, financial condition and results of operations may be adversely affected.

If we are unable to maintain or increase prices, our margins may decrease.

Our success depends in part upon our ability to persuade consumers to purchase our branded products, which generally command a price premium as compared to prices of Engineered and Private Label products. Some products in the Engineered market segment may be labeled as "natural" in accordance with the AAFCO regulatory definition even though they do not satisfy all the requirements of the Wholesome Natural market segment. These products are often priced lower than ours and even if we do not increase prices, consumers may choose to purchase such products instead of ours, based on the fact that such products cost less but yet are still labeled as "natural."

We rely in part on price increases to offset cost increases and improve the profitability of our business. Our ability to maintain prices or effectively implement price increases may be affected by a number of factors, including competition, effectiveness of our marketing programs, the continuing strength of our brand, market demand and general economic conditions, including inflationary pressures. In particular, in response to increased promotional activity by other pet food companies, we have in the past increased, and may in the future increase, our promotional spending, which for the period of the promotion, results in a lower average price per pound for our products and adversely impacts our gross margins. In addition, evolving customer dynamics in the grocery and mass channels may require us to increase our promotional spending in these channels, which may adversely impact our gross margins.

During challenging economic times, consumers may be less willing or able to pay a price premium for our branded products and may shift purchases to lower-priced or other value offerings, making it more difficult for us to maintain prices and/or effectively implement price increases. In addition, our retail partners and distributors may pressure us to rescind price increases that we have announced or already implemented, whether through a change in list price or increased promotional activity. If we are unable to maintain or increase prices for our products or must increase promotional activity, our margins may be adversely affected. Furthermore, price increases generally result in volume losses, as consumers purchase fewer units. If such losses are greater than expected or if we lose distribution due to a price increase, our business, financial condition and results of operations may be materially adversely affected.

If our products are alleged to cause injury or illness or fail to comply with governmental regulations, we may need to recall our products and may experience product liability claims.

Our products may be exposed to product recalls, including voluntary recalls or withdrawals, if they are alleged to cause or pose a risk of injury or illness or if they are alleged to have been mislabeled, misbranded or adulterated or to otherwise be in violation of governmental regulations. We may also voluntarily recall or withdraw products that we consider do not meet our standards, whether for palatability, appearance or otherwise, in order to protect our brand and reputation. For example, over the past three years, we issued five voluntary recalls, four of which were the result of errors occurring at third-party suppliers. These recalls resulted in a reduction to net sales and the incurrence of incremental expenses. If there is any future product recall or withdrawal that results in substantial and unexpected expenditures, destruction of product inventory, damage to our reputation or lost sales due to the unavailability of the product for a period of time, our business, financial condition and results of operations may be materially adversely affected.

We also may be subject to product liability claims if the consumption or use of our products is alleged to cause injury or illness. While we carry product liability insurance, our insurance may not be adequate to cover all liabilities we may incur in connection with product liability claims. For example, punitive damages are generally not covered by insurance. In addition, we may not be able to continue to maintain our existing insurance, obtain comparable insurance at a reasonable cost, if at all, or secure additional coverage, which may result in future product liability claims being uninsured. If there is a product liability judgment against us or a settlement agreement related to a product liability claim, our business, financial condition and results of operations may be materially adversely affected.

We are dependent on a relatively limited number of customers for a significant portion of our sales.

We sell our products to retail partners and distributors in specialty channels and recently commenced selling our products to grocery and mass retailers in the FDM channel. Our two largest retail partners, PetSmart (including Chewy.com as of an estimated acquisition date of June 1, 2017) and Petco, accounted for 41% and 18% of our net sales for the year ended December 31, 2017, 41% and 22% of our net sales for the year ended December 31, 2016, and 46% and 24% of our net sales for the year ended December 31, 2015, respectively. For the year ended December 31, 2017, we experienced significant growth in our net sales to eCommerce retailers and are becoming increasingly dependent on such retailers. If we were to lose any of our key customers, if any of our retail partners reduce the amount of their orders or if any of our key customers consolidate, reduce their store footprint and/or gain greater market power, our business, financial condition and results of operations may be materially adversely affected. In addition, national pet superstores have experienced reduced store traffic. If pet superstores continue to experience reduced store traffic, or experience any operational difficulties, we may be adversely affected. We may be similarly adversely impacted if any of our other key customers experience any operational difficulties or generate less traffic.

In addition, we do not enter into contracts with national pet superstores, eCommerce retailers, grocery and mass retailers, and certain other large retailers, that obligate them to buy, or us to sell, our products, and we do not have long-term contracts with our other customers. As a result, we rely on our consumers' continuing demand for our products and our position in the market for all purchase orders. We also rely on our retail partners carrying a broad selection of our products and working with us to execute in-store sales and marketing programs in order to differentiate our brands and drive consumer demand. If our retail partners or distributors are not satisfied with their margins on BLUE products due to changes in their expectations or due to changes to pricing strategies by us, our sales could decrease and our business, financial condition and results of operations may be materially adversely affected. We may be similarly negatively impacted if our retail partners change their pricing and margin expectations or business strategies as a result of our decision to expand distribution into grocery and mass retailers in the FDM channel, industry consolidation or otherwise, including a reduction or restriction of our in-store programs (both online and offline), a reduction in the number of brands they carry, a reduction or even elimination of the shelf space, or a change in the prominence of the shelf space they allocate to our products. They could even make a decision to stop selling our products altogether or increase emphasis on Private Label or other brands' products.

We rely upon a limited number of contract manufacturers to provide a significant portion of our supply of products. There is limited available manufacturing capacity that meets our quality standards. Our current plans to meet expected production needs rely in large part on successful ongoing operations at our Joplin Dry Food Facility and our new Heartland Richmond Facility and Joplin Treats Facility. Our Joplin Dry Food Facility may not, however, continue to operate in accordance with our expectations, and we may experience delays in the ramping up of our Joplin Treats Facility and the completion of construction and ramping up of our Heartland Richmond Facility.

We have agreements with a network of contract manufacturers that require them to provide us with specific finished products. Most of our agreements with our contract manufacturers automatically renew for consecutive one-year terms until notice of non-renewal is given. Upon expiration of our existing agreements with these contract manufacturers, or if our contract manufacturers were to merge or get acquired, we may not be able to renegotiate the terms of our agreements with these contract manufacturers on a commercially reasonable basis or at all.

During the years ended December 31, 2017, 2016 and 2015 approximately 43%, 41%, and 44%, respectively, of our cost of sales was derived from products purchased from the Company's five largest contract manufacturers. We manufacture our wet foods at two different locations owned by a single contract manufacturer and certain of our treats are also manufactured by single-source contract manufacturers. The manufacture of our products may not be easily transferable to other sites in the event that any of our contract manufacturers experience breakdown, failure or substandard performance of equipment, disruption of supply or shortages of raw materials and other supplies, labor problems, power outages, adverse weather conditions and natural disasters or the need to comply with environmental and other directives of governmental agencies. From time to time, a contract manufacturer may experience financial difficulties, bankruptcy or other business disruptions, which could disrupt our supply of finished goods or require that we incur additional expense by providing financial accommodations to the contract manufacturer or taking other steps to seek to minimize or avoid supply disruption, such as establishing a new contract manufacturing arrangement with another provider.

The loss of any of these contract manufacturers or the failure for any reason of any of these contract manufacturers to fulfill their obligations under their agreements with us, including a failure to meet our quality controls and standards, may result in disruptions to our supply of finished goods. We may be unable to locate an additional or alternate contract manufacturing arrangement that meets our quality controls and standards in a timely manner or on commercially reasonable terms, if at all.

To the extent our customers purchase products in excess of consumer consumption in any period, our sales in a subsequent period may be adversely affected as our customers seek to reduce their inventory levels.

From time to time, our customers may purchase more product than they expect to sell to consumers during a particular time period. Our customers may grow their inventory in anticipation of, or during, our promotional events, which typically provide for reduced prices during a specified time or other customer or consumer incentives. Our customers may also grow inventory in anticipation of a price increase for our products, or otherwise over-order our products as a result of overestimating demand for our products. If a customer increases its inventory during a particular reporting period as a result of a promotional event, anticipated price increase or otherwise, then sales during the subsequent reporting period may be adversely impacted as our customers seek to reduce their inventory levels. This effect may be particularly pronounced when the promotional event, price increase or other event occurs near the end or beginning of a reporting period or when there are changes in the timing of a promotional event, price increase or similar event, as compared to the prior year. To the extent our customers seek to reduce their usual or customary inventory levels or change their practices regarding purchases in excess of consumer consumption, our net sales and results of operations may be materially adversely affected in that period.

We operate in a highly competitive industry and may lose market share or experience margin erosion if we are unable to compete effectively.

The pet food industry is highly competitive. We compete on the basis of product quality and palatability, brand awareness and loyalty, product variety and ingredients, interesting product names, product packaging and package design, shelf space (both online and in-store), reputation, price and promotional efforts. We compete with a significant number of companies of varying sizes, including divisions or subsidiaries of larger companies that may have greater financial resources and larger customer bases than we have. As a result, these competitors may be able to identify and adapt to changes in consumer preferences more quickly than us due to their resources and scale. They may also be more successful in marketing and selling their products, better able to increase prices to reflect cost pressures and better able to increase their promotional activity, which may impact us and the entire pet food industry. Increased promotional activity may include increasing the size of packaging, which in turn has in the past reduced and may in the future reduce foot traffic at retailers and the number of opportunities we have to educate pet parents about the benefits of BLUE. In addition, these larger companies have entered the Wholesome Natural market segment and we expect them to continue to launch new Wholesome Natural brands, acquire existing Wholesome Natural brands, launch brand extensions or increase the promotion of existing Wholesome Natural brands and pet food products, all of which will increase our direct competition. We also compete with other companies who focus solely on manufacturing Wholesome Natural pet foods that may be smaller, more innovative and/or able to bring products to market faster and move more quickly to exploit and serve niche markets. If these competitive pressures cause our products to lose market share or experience margin erosion, our business, financial conditions and results of operations may be materially adversely affected.

We may face issues with respect to increased costs, disruption of supply or shortages of raw materials and other supplies, contaminations, adulterations or mislabeling.

We and our contract manufacturers use various raw materials and other supplies in our business, including ingredients, packaging materials and fuel. The prices of our raw materials and other supplies are subject to fluctuations attributable to, among other things, changes in supply and demand of crops or other commodities, weather conditions, agricultural uncertainty or governmental incentives and controls.

We generally do not have long-term supply contracts with our ingredient suppliers. The length of the contracts is fixed for a period of time, typically up to a year or for a season and/or a crop year. In addition, some of our raw materials are sole-sourced or sourced from a limited number of suppliers. We may not be able to renew or enter into new contracts with our existing suppliers following the expiration of such contracts on commercially reasonable terms, or at all. We purchase some of our raw materials in the open market, and although we aim to enter into fixed price and/or fixed quantity contracts for a pre-determined amount of our ingredients to reduce short term price volatility in certain commodities, these activities may not successfully reduce or stabilize the costs of our raw materials and supplies. If commodity prices increase or our procurement or future hedging activities are not effective, we may not be able to increase our prices to offset these increased costs. Moreover, our competitors may be better able than we are to implement productivity initiatives or effect price increases or to otherwise pass along cost increases to their customers.

Certain of our raw materials and supplies are imported from outside of the United States. Our ability to import these materials and supplies at a competitive price depends on our ability to properly manage our global supply chain, including our import processes. Changes in port management and procedures, the availability and cost of freight, regulatory changes, and our efforts to comply with import and export regulations in various countries may affect our supply chain and ultimately the pricing and availability of our products.

In addition, we face competition from other companies producing pet food and human food that are purchasing the same raw materials and supplies that are used in our products. This competition may lead to increased ingredient prices and affect our ability to produce sufficient volume of our product due to scarcity of certain ingredients.

Some of the raw materials we use are vulnerable to adverse weather conditions and natural disasters, such as floods, droughts, frosts, earthquakes and pestilences and may be impacted by climate change and other factors. Adverse weather conditions and natural disasters can reduce crop size and crop quality, which in turn could reduce supplies of raw materials, increase the prices of raw materials, increase costs of storing raw materials and interrupt or delay our production schedules if harvests are delayed. Our competitors may not be impacted by such weather conditions and natural disasters depending on the location of their suppliers and operations.

We conduct risk-based assessments of raw materials included in our products and implement monitoring of raw materials as appropriate based on those assessments. We may not be able to identify all relevant risks in a timely manner, if at all. If any of our raw materials or supplies are alleged or proven to include contaminants affecting the safety or quality of our products (including, for example, bacteria, mold or as a result of animal or human-related pandemics, such as outbreaks of bovine spongiform encephalopathy, foot-and-mouth disease, avian influenza, or any other disease), we may need to find alternate materials or supplies, delay production of our products, discard or otherwise dispose of our products, or engage in a product recall, all of which may have a materially adverse effect on our business, financial condition and results of operations.

We may be unable to detect or prevent the use of ingredients from our suppliers which do not meet our quality standards. Any use of such ingredients may result in a loss of consumer confidence in our brand and products and a reduction in our sales if consumers perceive us as being untruthful in our marketing and advertising and may materially adversely affect our brand, reputation, business, financial condition and results of operations.

If our sources of raw materials and supplies are terminated or affected by adverse prices, weather conditions or quality concerns, we may not be able to identify alternate sources of raw materials or other supplies that meet our quality controls and standards to sustain our sales volumes or on commercially reasonable terms, or at all.

Our Heartland Joplin Facilities may not operate in accordance with our expectations.

In 2014, we commenced manufacturing operations at our Joplin Dry Food Facility. Opening this facility and bringing this facility up to full production required significant capital expenditures and the efforts and attention of our management and other personnel, which diverted resources from our business operations. Maintaining and optimizing operations at our Joplin Dry Food Facility will continue to require certain capital expenditures as well as attention of our management and other personnel. In addition, we recently commenced operations at the Joplin Treats Facility, which is our first treats facility and is adjacent to our Joplin Dry Food Facility.

We expect our Joplin Dry Food Facility to provide us with in-house dry food manufacturing for approximately half of our forecasted dry food production needs over the next several years. This facility, however, may not provide us with the anticipated benefits. In addition, any substantial delay in ramping up the Joplin Treats Facility to full production on our schedule may hinder our ability to produce all of the product needed to meet orders and achieve our expected financial performance. Our Heartland Joplin Facilities are located in an area susceptible to tornadoes and other adverse weather conditions, and the damage or destruction of such facilities due to fire or natural disasters, including tornadoes, power failures or disruptions or equipment breakdown, failure or substandard performance could severely affect our ability to operate these facilities. Our Heartland Joplin Facilities and the manufacturing equipment we use to produce our products would be difficult or costly to replace or repair and may require substantial lead-time to do so. For example, if we were unable to use our Heartland Joplin Facilities, the use of any new facilities would need to be approved by various federal and local planning, zoning and health agencies, including the U.S. Department of Agriculture, the Missouri Department of Health and the Missouri Department of Agriculture, and registered with the FDA, in addition to passing our internal quality assurance requirements which may take up to 18 months and would result in significant production delays. We also may not be able to find suitable alternatives with contract manufacturers on a timely basis and at a reasonable cost. In addition, we may in the future experience plant shutdowns or periods of reduced production as a result of regulatory issues, equipment failure or delays in deliveries. Any such disruption or unanticipated event may cause significant interruptions or delays in our business and loss of inventory and/or data or render us unable to accept and fulfill customer orders in a timely manner, or at all. We have property and business disruption insurance coverage in place for our Heartland Joplin Facilities. However, such insurance coverage may not be sufficient to cover all of our potential losses and may not continue to be available to us on acceptable terms, or at all.

We may not successfully complete and open our additional dry food manufacturing facility or our additional dry food manufacturing facility may not operate in accordance with our expectations.

We are in the process of expanding our internal manufacturing capacity under our previously announced multi-year capital investment program. While we recently commenced operations at our Joplin Treats Facility, we also are close to completing the expansion of our internal manufacturing capabilities to provide additional dry production capacity commencing in the second half of 2018 at our Heartland Richmond Facility. We may experience substantial delays in completing the construction and implementation of our Heartland Richmond Facility. Any substantial delay in opening our Heartland Richmond Facility, registering the facility with appropriate regulatory authorities or bringing the facility up to full production on our schedule may hinder our ability to produce all of the product needed to meet orders and achieve our expected financial performance. Opening this facility and bringing it up to full production will require additional capital expenditures and the efforts and attention of our management and other personnel, which will divert resources from our existing business operations. If we miscalculate the resources or time we need to complete this projects or fail to implement the projects effectively, our business and operating results could be adversely affected. Even if our Heartland Richmond Facility begins operations according to our schedule, this facility may not provide us with the benefits that we expect to receive. If this facility do not provide us with the benefits that we expect to receive, our business and operating results could be adversely affected.

We may not be able to manage our manufacturing and supply chain effectively which may adversely affect our results of operations.

We must accurately forecast demand for our products in order to ensure we have adequate available manufacturing capacity. Our forecasts are based on multiple assumptions that may cause our estimates to be inaccurate and affect our ability to obtain adequate manufacturing capacity (whether our own manufacturing capacity or contract manufacturing capacity) in order to meet the demand for our products, which could prevent us from meeting increased customer or consumer demand and harm our brand and our business. However, if we overestimate our demand and overbuild our capacity, we may have significantly underutilized assets and may experience reduced margins. If we do not accurately align our manufacturing capabilities with demand, our business, financial condition and results of operations may be materially adversely affected.

In addition, we must continuously monitor our inventory and product mix against forecasted demand. If we underestimate demand, we risk having inadequate supplies. We also face the risk of having too much inventory on hand that may reach its expiration date and become unsaleable, and we may be forced to rely on markdowns or promotional sales to dispose of excess or slow-moving inventory. If we are unable to manage our supply chain effectively, our operating costs could increase and our profit margins could decrease.

We rely upon a number of third parties to manage or provide distribution centers for our products.

In addition to our Heartland Joplin warehouse, which we operate, our distribution operations include the use of third-party distribution centers as well as the use of third parties to manage such distribution centers. These third-party distribution centers may distribute our products as well as the products of other companies. Our distribution operations at these third-party distribution centers could be disrupted by a number of factors, including labor issues, failure to meet customer standards, bankruptcy or other financial issues affecting our third-party providers, or other issues affecting any such third party’s ability to service our customers effectively. If there is any disruption of these distribution centers, our business may be materially adversely affected. As we expand the distribution of products in the FDM channel, we may not be able to accurately forecast our manufacturing or warehousing needs or may encounter difficulty obtaining additional storage if and when such additional storage is needed.

If we continue to grow, we may not be able to manage our growth effectively.

Our net sales have grown from $1,027.4 million in 2015 to $1,149.8 million in 2016 to $1,274.6 million in 2017. Our historical rapid growth, and continued growth as a CPG company, has placed and, if continued, may continue to place significant demands on our management and our operational and financial resources. Our organizational structure may become more complex as we add additional staff, and we may require valuable resources to grow and continue to improve our operational, management and financial controls without undermining our strong corporate culture of entrepreneurship and collaboration that has been a strong contributor to our growth so far. If we are not able to manage our growth effectively, our business, financial condition and results of operations may be materially adversely affected.

Our market size estimate may prove to be inaccurate.

Data for pet food retail sales is collected for most, but not all channels, and as a result, it is difficult to estimate the size of the market and predict the rate at which the market for our products will grow, if at all. While our market size estimate was made in good faith, is within the range of a major independent third-party estimate of the U.S. pet food industry and is based on assumptions and estimates we believe to be reasonable, this estimate may not prove to be accurate.

We may face difficulties as we expand in and into countries in which we have no prior operating experience.

We have expanded and intend to continue to expand our global footprint by entering into new markets. As we expand our business into new countries we will encounter foreign economic, political, regulatory, personnel, technological, language barriers and other risks that may increase our expenses or delay our ability to become profitable in such countries. These risks include:

- fluctuations in currency exchange rates;
- the difficulty of enforcing agreements and collecting receivables through some foreign legal systems;
- customers in some foreign countries potentially having longer payment cycles;
- changes in local tax laws, tax rates in some countries that may exceed those of the United States or Canada and lower earnings due to withholding requirements or the imposition of tariffs, exchange controls or other restrictions;
- seasonal reductions in business activity;
- port conditions and the pricing of freight transport;
- the credit risk of local customers and distributors;
- general economic and political conditions;
- any attempt by the Trump administration to withdraw from or materially modify the North American Free Trade Agreement (“NAFTA”) and certain other international trade agreements;
- unexpected changes in legal, regulatory or tax requirements;
- unexpected changes in import and export regulations, processes and procedures;
- differences in culture and trends in foreign countries with respect to pets and pet care;
- the difficulties associated with managing a large global organization;
- the risk that certain governments may adopt regulations or take other actions that would have a direct or indirect adverse impact on our business and market opportunities, including nationalization of private enterprise;
- non-compliance with applicable currency exchange control regulations, transfer pricing regulations or other similar regulations;
- violations of the Foreign Corrupt Practices Act or comparable local anticorruption laws by acts of agents and other intermediaries whom we have limited or no ability to control; and

- violations of regulations enforced by the U.S. Department of The Treasury's Office of Foreign Asset Control.

In addition, our expansion into new countries may require significant resources and the efforts and attention of our management and other personnel, which will divert resources from our existing business operations. As we expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our operations outside of the United States and Canada.

We may face challenges growing our line of veterinary exclusive therapeutic products.

We have launched, and are seeking to expand, our line of veterinary exclusive therapeutic products. This market segment is dominated by divisions of larger companies that have made substantial investments in their veterinary exclusive therapeutic products over many years and have developed close relationships with veterinarians and veterinary clinics. If we are not able successfully to develop relationships with veterinarians and veterinary clinics, or engage with academics and new veterinary professionals, we may not be able to grow our sales of veterinary exclusive products. Our competitors continue to grow their lines of products in this market segment, resulting in increased competition for our line of products. In addition, these companies have a significantly larger number of veterinary sales representatives, and may have greater financial resources and the ability to fulfill product orders more quickly than we do.

Our expansion into the veterinary exclusive segment will require significant resources and the efforts and attention of our management and other personnel, which will divert resources from our existing business operations. As a result, we may not be able successfully to implement our veterinary exclusive therapeutic product growth strategy and may need to change our strategy. If we fail to implement this growth strategy or if we continue to invest resources in this strategy and it ultimately proves unsuccessful, our business, financial condition and results of operations may be materially adversely affected.

We may seek to grow our business through acquisitions of or investments in new or complementary businesses, facilities, technologies or products, or through strategic alliances, and the failure to manage acquisitions, investments or strategic alliances, or the failure to integrate them with our existing business, could have a material adverse effect on us.

From time to time we may consider opportunities to acquire or make investments in new or complementary businesses, facilities, technologies or products, or enter into strategic alliances, that may enhance our capabilities, expand our manufacturing network, add new brands to our portfolio, complement our current products or expand the breadth of our markets. Potential and completed acquisitions and investments and other strategic alliances involve numerous risks, including:

- problems assimilating the purchased business, facilities, technologies or products;
- issues maintaining uniform standards, procedures, controls and policies;
- unanticipated costs associated with acquisitions, investments or strategic alliances;

- diversion of management's attention from our existing business;
- adverse effects on existing business relationships with suppliers, contract manufacturers, retail partners and distribution customers;
- increased complexity of running a broader portfolio of products, brands or facilities, which may conflict with our existing business;
- risks associated with entering new markets in which we have limited or no experience;
- potential loss of key employees of acquired businesses; and
- increased legal and accounting compliance costs.

We do not know if we will be able to identify acquisitions or strategic relationships we deem suitable, whether we will be able to successfully complete any such transactions on favorable terms or at all, or whether we will be able to successfully integrate any acquired business, facilities, technologies or products into our business or retain any key personnel, suppliers or customers. Our ability successfully to grow through strategic transactions depends upon our ability to identify, negotiate, complete and integrate suitable target businesses, facilities, technologies and products and to obtain any necessary financing. These efforts could be expensive and time-consuming and may disrupt our ongoing business and prevent management from focusing on our operations. If we are unable to integrate any acquired businesses, facilities, technologies and products effectively, our business, results of operations and financial condition could be materially adversely affected.

Our substantial indebtedness may have a material adverse effect on our business, financial condition and results of operations.

As of December 31, 2017, we had a total of $398.0 million of indebtedness, consisting of amounts outstanding under our term loan facilities, and a total availability of $120.0 million under our revolving credit facility. Our indebtedness could have significant consequences, including:

- requiring a substantial portion of our cash flows to be dedicated to debt service payments instead of funding growth, working capital, capital expenditures, investments or other cash requirements;
- reducing our flexibility to adjust to changing business conditions or obtain additional financing;
- exposing us to the risk of increased interest rates as certain of our borrowings, including borrowings under our term loan facilities are at variable rates;
- making it more difficult for us to make payments on our indebtedness;
- restricting us from making strategic acquisitions or causing us to make non-strategic divestitures;
- subjecting us to restrictive covenants that may limit our flexibility in operating our business; and
- limiting our ability to obtain additional financing for working capital, capital expenditures, debt service requirements and general corporate or other purposes.

If our cash from operations is not sufficient to meet our current or future operating needs, expenditures and debt service obligations, our business, financial condition and results of operations may be materially adversely affected.

Our ability to generate cash to meet our operating needs, expenditures and debt service obligations will depend on our future performance and financial condition, which will be affected by financial, business, economic legislative, regulatory and other factors, including potential changes in costs, pricing, the success of product innovation and marketing, competitive pressure and consumer preferences. If our cash flow and capital resources are insufficient to fund our debt service obligations and other cash needs, we could face substantial liquidity problems and could be forced to reduce or delay investments and capital expenditures or to dispose of material assets or operations, seek additional debt or equity capital or restructure or refinance our indebtedness. Our revolving credit facility and our term loan facilities restrict our ability to take these actions and we may not be able to affect any such alternative measures on commercially reasonable terms or at all. If we cannot make scheduled payments on our debt, the lenders under our senior secured credit facilities can terminate their commitments to loan money, can declare all outstanding principal and interest to be due and payable and foreclose against the assets securing their borrowings and we could be forced into bankruptcy or liquidation. In addition, any downgrade of our debt ratings by any of the major rating agencies, which could result from our financial performance, acquisitions or other factors, would also negatively impact our access to additional debt financing (including leasing) or refinancing on favorable terms, or at all. Even if we are successful in taking any such alternative actions, such actions may not allow us to meet our scheduled debt service obligations and, as a result, our business, financial condition and results of operations may be materially adversely affected.

Failure to protect our intellectual property could harm our competitive position or require us to incur significant expenses to enforce our rights.

Our trademarks such as “Blue Buffalo,” “LifeSource Bits,” “Life Protection Formula,” “BLUE Wilderness,” “BLUE Basics,” “BLUE Freedom,” and “BLUE Natural Veterinary Diet” along with the BLUE shield logo, the Blue Buffalo figure logo and the tag line “Love them like family. Feed them like family.” are valuable assets that support our brand and consumers’ perception of our products. We rely on trademark, copyright, trade secret, patent and other intellectual property laws, as well as nondisclosure and confidentiality agreements and other methods, to protect our trademarks, trade names, proprietary information, technologies and processes. Our non-disclosure agreements and confidentiality agreements may not effectively prevent disclosure of our proprietary information, technologies and processes and may not provide an adequate remedy in the event of unauthorized disclosure of such information, which could harm our competitive position. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited for some of our trademarks, inventions and other proprietary information and patents in some foreign countries. We may need to engage in litigation or similar activities to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of proprietary rights of others. Further, third parties may also engage in litigation or similar activities to challenge the validity and scope of our intellectual property and proprietary rights. Any such litigation could require us to expend significant resources and divert the efforts and attention of our management and other personnel from our business operations. If we fail to protect our intellectual property, our business, financial condition and results of operations may be materially adversely affected.

We may be subject to intellectual property infringement claims or other allegations, which could result in substantial damages and diversion of management's efforts and attention.

We have obligations with respect to the non-use and non-disclosure of third-party intellectual property. The steps we take to prevent misappropriation, infringement or other violation of the intellectual property of others may not be successful. From time to time, third parties have asserted intellectual property infringement claims against us and our customers and may continue to do so in the future.

While we believe that our products do not infringe in any material respect upon proprietary rights of other parties and/or that meritorious defenses would exist with respect to any assertions to the contrary, we may from time to time be found to infringe on the proprietary rights of others. For example, patent applications in the United States and some foreign countries are generally not publicly disclosed until the patent is issued or published and we may not be aware of currently filed patent applications that relate to our products or processes. If patents later issue on these applications, we may be found liable for subsequent infringement.

Any claims that our products or processes infringe these rights, regardless of their merit or resolution, could be costly and may divert the efforts and attention of our management and technical personnel. We may not prevail in such proceedings given the complex technical issues and inherent uncertainties in intellectual property litigation. If such proceedings result in an adverse outcome, we could, among other things, be required to:

- pay substantial damages (potentially treble damages in the United States);
- cease the manufacture, use or sale of the infringing products;
- discontinue the use of the infringing processes;
- expend significant resources to develop non-infringing processes; and
- enter into licensing arrangements from the third party claiming infringement, which may not be available on commercially reasonable terms, or may not be available at all.

If any of the foregoing occurs, our ability to compete could be affected or our business, financial condition and results of operations may be materially adversely affected.

A failure of one or more key information technology systems, networks, or processes may materially adversely affect our ability to conduct our business.

The efficient operation of our business depends on our information technology systems. We rely on our information technology systems to effectively manage our sales and marketing, accounting and financial and legal and compliance functions, engineering and product development tasks, research and development data, communications, supply chain, order entry and fulfillment and other business processes. The failure of our information technology systems to perform as we anticipate could disrupt our business and could result in transaction errors, processing inefficiencies and the loss of sales and customers, causing our business and results of operations to suffer. In addition, our information technology systems may be vulnerable to damage or interruption from circumstances beyond our control, including fire, natural disasters, power outages, systems failures, security breaches, cyber-attacks, ransomware and computer viruses. The failure of our information technology systems to perform as we anticipate or our failure to effectively implement new systems could disrupt our entire operation and could result in decreased sales, increased overhead costs, excess inventory and product shortages and a loss of important information. Further, to the extent that we may have customer or consumer information in our databases, any unauthorized disclosure of, or access to, such information could result in claims under data protection laws and regulations. If any of these risks materialize, our reputation and our ability to conduct our business may be materially adversely affected.

We are subject to extensive governmental regulation and we may incur material costs in order to comply with existing or future laws and regulation, and our failure to comply may result in enforcement, recalls and other adverse actions.

We are subject to a broad range of federal, state and local laws and regulations intended to protect public health, natural resources and the environment. See “Business-Government Regulation.” Our operations are subject to regulation by the Occupational Safety and Health Administration, the FDA, the Department of Agriculture ("USDA"), and by various state, local and foreign authorities regarding the processing, packaging, storage, distribution, advertising, labeling and export of our products, including food safety standards.

Among other regulatory requirements, the FDA reviews the inclusion of specific claims in pet food labeling, such as claims regarding “hairball control” and “urinary tract health.” We currently produce pet food products, such as cat food with hairball management claims, which undergo FDA pre-market review. These products, as well as other of our products, such as those in our BLUE Natural Veterinary Diet line, provide all or most of the nutrients in support of an animal’s total daily nutrient needs but are also labeled or marketed with claims that may suggest that they are intended to treat or prevent disease, thereby potentially meeting the statutory definitions of both a food and a drug. The FDA recently issued guidance containing a list of specific factors it will consider in determining whether to initiate enforcement action against such products if they do not comply with the regulatory requirements applicable to drugs. These factors include, among other things, whether the product is only made available through or under the direction of a veterinarian and does not present a known safety risk when used as labeled. While we believe that we market our products in compliance with the policy articulated in FDA’s guidance and in other claim-specific guidance, the FDA may disagree or may classify some of our products differently than we do, and may impose more stringent regulations which could lead to alleged regulatory violations, enforcement actions and product recalls. For example, a manufacturer of animal drugs must comply with the FDA’s GMPs for the manufacture of pharmaceutical products and is subject to FDA inspection to confirm its compliance. In addition, we may produce more products that may be subject to FDA pre-market review, including new products we introduce to the Therapeutic market segment.

The FDA Food Safety Modernization Act provides direct recall authority to the FDA and includes a number of other provisions designed to enhance food safety, including increased inspections by the FDA of domestic and foreign food facilities and increased review of food products imported into the United States. In addition to periodic government agency inspections affecting our operations generally, our Heartland Joplin Facilities are, and our Heartland Richmond Facility will be, subject to mandatory continuous on-site inspections by the FDA, and certain of our raw material suppliers are subject to mandatory continuous on-site inspection by the USDA. The FSMA also mandates that the FDA adopt preventative controls to be implemented by pet food facilities in order to minimize or prevent hazards to food safety. Under the FSMA, the FDA finalized the Current Good Manufacturing Practice (CGMP), Hazard Analysis, and Risk-Based Preventive Controls for Food for Animals on September 17, 2015. The final rule has staggered compliance dates based on the business size. There are two components of the final rule with different compliance dates including CGMP requirements and the Preventive Controls. Blue Buffalo was required to be in compliance with the CGMP by September 2016 and was required to be in compliance with the Preventive Controls by September 2017. The FDA also finalized the Foreign Supplier Verification Program (FSVP) on November 27, 2015, with a compliance date of July 2017. The third relevant regulation is the Sanitary Transportation of Human and Animal Food, which had a compliance date of April 6, 2017. We believe that we are in compliance with those regulations in effect that are relevant to our business.

Complying with government regulation can be costly or may otherwise adversely affect our business. Our business is also affected by import and export controls and similar laws and regulations, both in the United States and elsewhere. Issues such as national security or health and safety, which may slow or otherwise restrict imports or exports, may adversely affect our business. Violations of or liability under any of these laws and regulations may result in administrative, civil or criminal penalties against us, revocation or modification of applicable permits, environmental investigations or remedial activities, voluntary or involuntary product recalls, warning or untitled letters or cease and desist orders against operations that are not in compliance, among other things. These laws and regulations may change in the future and we may incur (directly, or indirectly through our contract manufacturers) material costs to comply with current or future laws and regulations or in any required product recalls. In addition, we and our contract manufacturers are subject to additional regulatory requirements, including compliance with the environmental, health and safety laws and regulations administered by the U.S. Environmental Protection Agency, state environmental regulatory agencies (including the Missouri Department of Natural Resources and the Indiana Department of Natural Resources) and the National Labor Relations Board. Such laws and regulations generally have become more stringent over time and may become more so in the future. Costs of compliance, and the impacts on us of any non-compliance, with any such laws and regulations could materially adversely affect our business, financial condition and results of operations.

There is no single U.S. government regulated definition of the term “natural” for use in the pet food industry. On November 10, 2015, the FDA requested public comments on the use of the term “natural” in the labeling of human food products. Comments were due on or before May 10, 2016. It is unclear whether the FDA will engage in rulemaking and, if so, whether any resulting regulation would impact the pet food industry.

Currently, many states in the United States have adopted the AAFCO definition of the term “natural” with respect to the pet food industry, which means no synthetic additives or synthetic processing except vitamins, minerals or certain trace nutrients, and only ingredients that are derived solely from plant, animal or mined sources. Certain groups and individuals have proposed requiring pet food labeling to disclose the presence or use of genetically modified organisms, or GMOs. We may incur material costs to comply with any new GMO-labeling requirements, and could be subject to liabilities if we fail to timely comply. If any of these changes materialize, our reputation, business, financial condition and results of operations may be materially adversely affected.

Our operations are also subject to the laws of, and regulation by governmental authorities in, Canada, including the Canadian Food Inspection Agency, and provincial and local regulations; Mexico, including the Secretariat of Agriculture, Livestock, Rural Development, Fisheries and Food; Japan, including the Ministry of Agriculture, Forestry and Fisheries and the Ministry of the Environment; and comparable regulators in other countries where our products are sold.

Adverse litigation judgments or settlements resulting from legal proceedings relating to our business operations could materially adversely affect our business, financial condition and results of operations.

From time to time, we are subject to allegations, and may be party to legal claims and regulatory proceedings, relating to our business operations. Such allegations, claims and proceedings may be brought by third parties, including our customers, employees, governmental or regulatory bodies or competitors. Defending against such claims and proceedings is costly and time consuming and may divert management’s attention and personnel resources from our normal business operations, and the outcome of many of these claims and proceedings cannot be predicted. If any of these claims or proceedings were to be determined adversely to us, a judgment, a fine or a settlement involving a payment of a material sum of money were to occur, or injunctive relief were issued against us, our business, financial condition and results of operations could be materially adversely affected.

Our success depends on our ability to attract and retain key employees and the succession of senior management as well as team members within stores.

Our continued growth and success requires us to hire, retain and develop our leadership bench. If we are unable to attract and retain talented, highly qualified senior management and other key executives, as well as provide for the succession of senior management, our growth and results of operations may be adversely impacted.

Our success also depends on our ability to continue to attract, motivate and retain employees who understand and appreciate our culture and are able to represent our brand effectively, including our Pet Detectives who interact with consumers in stores. If we are unable to attract, train and retain new employees and new team members to act as Pet Detectives, this could delay or prevent the implementation of our business strategy and in turn, lead to fewer sales of our products. In addition, we have in the past been a defendant in a purported class action by former and current Pet Detectives, which alleged certain violations of wage and labor laws in California and Oregon, and we may be subject to other claims in the future.

Risks Related to Ownership of our Common Stock

We are a “controlled company” within the meaning of NASDAQ rules and, as a result, qualify for exemptions from certain corporate governance requirements.

Together, Invus and The Bishop Family Limited Partnership constitute a “group” that controls a majority of the voting power of our outstanding common stock. Under NASDAQ rules a listed company of which more than 50% of the voting power for the election of directors is held by another person or group of persons acting together is a “controlled company” and such a company may elect not to comply with certain NASDAQ corporate governance requirements, including the requirements (i) that a majority of the Board of Directors consist of independent directors, (ii) to have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities and (iii) to have director nominations be made, or recommended to the full Board of Directors, by independent directors or by a nominations committee that is composed entirely of independent directors and to adopt a written charter or board resolution addressing the nominations process. We have elected to be treated as a "controlled company." Accordingly, our stockholders may not have the same protections afforded to stockholders of companies that are subject to all of the NASDAQ corporate governance requirements.

Invus controls us and its interests may conflict with yours in the future.

Invus beneficially owns approximately 44.7% of our common stock. Invus effectively controls us and will effectively be able to control the election and removal of our directors and thereby determine our corporate and management policies, including potential mergers or acquisitions, payment of dividends, asset sales, amendment of our amended and restated certificate of incorporation or amended and restated bylaws and other significant corporate transactions for so long as Invus and its affiliates retain significant ownership of us. This concentration of our ownership may delay or deter possible changes in control of the Company, which may reduce the value of an investment in our common stock. So long as Invus continues to own a significant amount of our combined voting power, Invus will continue to be able to strongly influence or effectively control our decisions and, so long as Invus and its affiliates collectively own at least 5% of all outstanding shares of our stock entitled to vote generally in the election of directors, it will be able to appoint individuals to our Board of Directors under the amended and restated investor rights agreement we have entered into with Invus. The interests of Invus may not coincide with the interests of other holders of our common stock.

In the ordinary course of their business activities, Invus and its affiliates may engage in activities where their interests conflict with our interests or those of our stockholders. Our amended and restated certificate of incorporation provides that none of Invus, any of its affiliates or any director who is not employed by us (including any non-employee director who serves as one of our officers in both his director and officer capacities) or his or her affiliates will have any duty to refrain from engaging, directly or indirectly, in the same business activities or similar business activities or lines of business in which we operate. Invus also may pursue acquisition opportunities that may be complementary to our business and, as a result, those acquisition opportunities may not be available to us. In addition, Invus may have an interest in pursuing acquisitions, divestitures and other transactions that, in its judgment, could enhance its investment, even though such transactions might involve risks to you.

We have incurred and will continue to incur increased costs, and are subject to additional regulations and requirements as a result of being a public company, and our management will be required to devote substantial time to compliance matters, which could lower our profits or make it more difficult to run our business.

As a public company, we have incurred and will continue to incur significant legal, accounting and other expenses that we did not incur as a private company, including costs associated with public company reporting requirements and costs of recruiting and retaining non-executive directors. We also have incurred and will incur costs associated with the Sarbanes-Oxley Act and related rules implemented by the Securities and Exchange Commission, or the SEC, and NASDAQ. The expenses incurred by public companies generally for reporting and corporate governance purposes have been increasing. These rules and regulations have increased, and will continue to increase, our legal and financial compliance costs and make some activities more time-consuming and costly. Our management will need to devote a substantial amount of time to ensure that we comply with all of these requirements. These laws and regulations also could make it more difficult or costly for us to obtain certain types of insurance, including director and officer liability insurance, and we may be forced to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. These laws and regulations could also make it more difficult for us to attract and retain qualified persons to serve on our Board of Directors, our board committees or as our executive officers. Furthermore, if we are unable to satisfy our obligations as a public company, we could be subject to delisting of our common stock, fines, sanctions and other regulatory action and potentially civil litigation.

The market price of shares or our common stock may be volatile, which could cause the value of your investment to decline.

The trading price of our common stock has been, and may continue to be, volatile. Securities markets worldwide experience significant price and volume fluctuations. This market volatility, as well as general economic, market or political conditions, could reduce the market price of shares of our common stock in spite of our operating performance. In addition, our results of operations could be below the expectations of public market analysts and investors due to a number of potential factors, including variations in our quarterly results of operations, additions or departures of key management personnel, failure to meet analysts' earnings estimates, publication of research reports about our industry, litigation and government investigations, changes or proposed changes in laws or regulations or differing interpretations or enforcement thereof affecting our business, adverse market reaction to any indebtedness we may incur or securities we may issue in the future, changes in market valuations of similar companies or speculation in the press or investment community, announcements by our competitors of significant contracts, acquisitions, dispositions, strategic partnerships, joint ventures or capital commitments, and adverse publicity about our industry or individual scandals. In response, the market price of shares of our common stock could decrease significantly. You may be unable to resell your shares of common stock at or above the price you paid or at all.

In the past few years, stock markets have experienced extreme price and volume fluctuations. In the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

If we are unable to maintain effective internal control over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock may be negatively affected.

As a public company, we are required to maintain internal controls over financial reporting and to report any material weaknesses in such internal controls. In addition, we are required to furnish with each annual report on Form 10 K, a report by management on the effectiveness of our internal control over financial reporting and our independent registered public accountants are required to attest to the effectiveness of our internal control over financial reporting, in each case pursuant to Section 404 of the Sarbanes-Oxley Act. At such time, our independent registered public accounting firm may issue a report that is adverse in the event it is not satisfied with the level at which our internal control over financial reporting is documented, designed or operating.

The process of designing, implementing, maintaining and testing the internal control over financial reporting required to comply with this obligation is time-consuming, costly, and complicated. If we identify material weaknesses in our internal control over financial reporting, if we are unable to comply with the requirements of Section 404 of the Sarbanes-Oxley Act in a timely manner or to assert that our internal control over financial reporting is effective, or if our independent registered public accounting firm is unable to express an opinion as to the effectiveness of our internal control over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock could be negatively affected, and we could become subject to investigations by the NASDAQ, the SEC, or other regulatory authorities, which could require additional financial and management resources.

Because we have no current plans to pay cash dividends on our common stock, you may not receive any return on investment unless you sell your common stock for a price greater than that which you paid for it.

We have no current plans to pay cash dividends on our common stock. The declaration, amount and payment of any future dividends will be at the sole discretion of our Board of Directors. Our Board of Directors may take into account general and economic conditions, our financial condition and results of operations, our available cash and current and anticipated cash needs, capital requirements, contractual, legal, tax and regulatory restrictions and implications on the payment of dividends by us to our stockholders or by our subsidiaries to us, including restrictions under our senior secured credit facilities and other indebtedness we may incur, and such other factors as our Board of Directors may deem relevant.

Blue Buffalo Pet Products, Inc. is a holding company with no operations of its own and, as such, it depends on its subsidiaries for cash to fund all of its operations and expenses, including future dividend payments, if any.

Our operations are conducted almost entirely through our subsidiaries and our ability to generate cash to meet our debt service obligations or to make future dividend payments, if any, is highly dependent on the earnings and the receipt of funds from our subsidiaries via dividends or intercompany loans. We do not currently expect to declare or pay dividends on our common stock for the foreseeable future; however, to the extent that we determine in the future to pay dividends on our common stock, the credit agreement governing our revolving credit facility significantly restricts the ability of our subsidiaries to pay dividends or otherwise transfer assets to us. In addition, Delaware law may impose requirements that may restrict our ability to pay dividends to holders of our common stock.

You may be diluted by the future issuance of additional common stock in connection with our incentive plans, acquisitions or otherwise.

As of December 31, 2017, we had approximately 1,302 million shares of common stock authorized but unissued. Our amended and restated certificate of incorporation authorizes us to issue these shares of common stock and options relating to common stock for the consideration and on the terms and conditions established by our Board of Directors in its sole discretion, whether in connection with acquisitions or otherwise. As of December 31, 2017, we have 205,978 shares reserved for issuance under the Amended and Restated 2012 Stock Purchase and Option Plan of Blue Buffalo Pet Products, Inc. (the "2012 Plan") and 7,552,780 shares reserved for issuance under the Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (the "2015 Plan"). Any common stock that we issue, including under the 2012 Plan, the 2015 Plan or other equity incentive plans that we may adopt in the future, may result in additional dilution to you.

Future sales, or the perception of future sales, by us or our existing stockholders in the public market could cause the market price for our common stock to decline.

The sale of a substantial number of shares of our common stock in the public market, or the perception that such sales could occur, including sales by Invus, could harm the prevailing market price of shares of our common stock. These sales, or the possibility that these sales may occur, also might make it more difficult for us to sell equity securities in the future at a time and at a price that we deem appropriate.

Shares held by Invus and certain of our directors, officers and employees are eligible for resale, subject to volume, manner of sale and other limitations under Rule 144. In addition, pursuant to an investor rights agreement entered into on July 10, 2012 and amended and restated on January 21, 2015, we granted Invus the right, subject to certain conditions, to require us to register the sale of its shares of our common stock under the Securities Act.

If Invus exercises its registration rights, the market price of our shares of common stock could drop significantly if the holders of these shares sell them or are perceived by the market as intending to sell them. These factors could also make it more difficult for us to raise additional funds through future offerings of our shares of common stock or other securities.

Anti-takeover provisions in our organizational documents and Delaware law might discourage or delay acquisition attempts for us that you might consider favorable.

Our amended and restated certificate of incorporation and amended and restated bylaws contain provisions that may make the merger or acquisition of the Company more difficult without the approval of our Board of Directors. Among other things:

- although we do not have a stockholder rights plan, these provisions allow us to authorize the issuance of undesignated preferred stock in connection with a stockholder rights plan or otherwise, the terms of which may be established and the shares of which may be issued without stockholder approval, and which may include super voting, special approval, dividend, or other rights or preferences superior to the rights of the holders of common stock;
- these provisions provide for a classified Board of Directors with staggered three-year terms;
- these provisions require advance notice for nominations of directors by stockholders and for stockholders to include matters to be considered at our annual meetings;

- these provisions prohibit stockholder action by written consent from and after the date on which Invus, The Bishop Family Limited Partnership, or The Bishop Family Partnership, and their affiliates beneficially own, in the aggregate, less than 40% of our outstanding shares of common stock;
- these provisions provide for the removal of directors only for cause and only upon affirmative vote of holders of at least 66 2/3% of the shares of common stock entitled to vote generally in the election of directors if Invus, The Bishop Family Partnership and their affiliates beneficially own, in the aggregate, less than 40% of our outstanding shares of common stock; and
- these provisions require the amendment of certain provisions only by the affirmative vote of at least 66 2/3% of the shares of common stock entitled to vote generally in the election of directors if Invus, The Bishop Family Partnership and their affiliates beneficially own, in the aggregate, less than 40% of our outstanding shares of common stock.

Further, as a Delaware corporation, we are also subject to provisions of Delaware law, which may impair a takeover attempt that our stockholders may find beneficial. These anti-takeover provisions and other provisions under Delaware law could discourage, delay or prevent a transaction involving a change in control of the Company, including actions that our stockholders may deem advantageous, or negatively affect the trading price of our common stock. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and to cause us to take other corporate actions you desire.

Our Board of Directors is authorized to issue and designate shares of our preferred stock in additional series without stockholder approval.

Our amended and restated certificate of incorporation authorizes our Board of Directors, without the approval of our stockholders, to issue 150 million shares of our preferred stock, subject to limitations prescribed by applicable law, rules and regulations and the provisions of our amended and restated certificate of incorporation, as shares of preferred stock in series, to establish from time to time the number of shares to be included in each such series and to fix the designation, powers, preferences and rights of the shares of each such series and the qualifications, limitations or restrictions thereof. The powers, preferences and rights of these additional series of preferred stock may be senior to or on parity with our common stock, which may reduce its value.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The following table sets forth the location, size, use and lease expiration date of our key properties as of December 31, 2017. The majority of our properties are leased. The leases expire at various times through 2027, subject to renewal options.

| Location | Approximate Square Footage | Principal Use | Owned or Leased |
|---|---|---|---|
| Joplin, Missouri | 200,000 | Manufacturing | Leased, expires December 2027 |
| | 215,000 | Distribution/warehousing/office | Owned |
| Monroe, Ohio | 535,000 | Distribution/warehousing | Leased; expires December 2023 |
| Bellevue, Nebraska | 370,000 | Distribution/warehousing | Leased; expires May 2025 |
| Wilton, Connecticut | 41,000 | Corporate headquarters | Leased; expires June 2021 |
| Phoenix, Arizona | 8,600 | Sales office | Leased; expires December 2018 |

ITEM 3. LEGAL PROCEEDINGS

We are a party to a number of pending claims and lawsuits arising in the normal course of business, including proceedings involving tort and other general liability claims, workers' compensation and other employee claims, and claims relating to our advertising and intellectual property.

We maintain general and other liability insurance; however, certain costs of defending lawsuits are not covered by or are only partially covered by insurance policies, and our insurance carriers could refuse to cover certain claims in whole or in part. We regularly evaluate our ultimate liability with respect to such claims and lawsuits. We accrue potential losses from litigation as they become probable and estimable.

We do not consider our ultimate liability with respect to any single claim or lawsuit, or the aggregate of such claims and lawsuits, to be material in relation to our consolidated financial condition, results of operations, or our cash flows taken as a whole.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR THE REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is listed and traded on the NASDAQ Stock Market LLC (the “NASDAQ”) under the symbol “BUFF”.

The following table sets forth the high and low sale prices per share of our common stock on the NASDAQ for the periods indicated:

| | Market Price | |
|---|---|---|
| Fiscal Year Ended December 31, 2017 | High | Low |
| Fourth Quarter | $33.09 | $25.00 |
| Third Quarter | 28.96 | 21.51 |
| Second Quarter | 25.44 | 21.71 |
| First Quarter | 25.96 | 22.85 |
| Fiscal Year Ended December 31, 2016 | | |
| Fourth Quarter | $26.03 | $21.60 |
| Third Quarter | 27.50 | 23.16 |
| Second Quarter | 27.37 | 22.50 |
| First Quarter | 25.98 | 15.19 |

Holders

The number of holders of record of our common stock as of February 20, 2018 was 80. This stockholder figure does not include a substantially greater number of holders whose shares are held of record by banks, brokers, and other financial institutions.

Stock Performance Graph

The following graph compares the cumulative total stockholder return on the Company’s common stock with that of the S&P 500, the S&P 500 Consumer Staples, and the S&P MidCap 400. The period shown commences on July 22, 2015, which is the date our common stock began trading on the NASDAQ, and ends on December 31, 2017, the end of our last fiscal year. The graph assumes $100 was invested at the close of market on July 22, 2015 in the Company's common stock, the S&P 500, S&P 500 Consumer Staples, and the S&P MidCap 400, and assumes the reinvestment of any dividends. The stock price performance on the following graph is not intended to forecast or be indicative of future stock price performance of the Company's common stock. This performance graph shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liabilities under that Section, and shall not be deemed to be incorporated by reference into any filing of the Company under the Securities Act of 1933, as amended, or the Exchange Act.

Dividends

We have not declared or paid any cash dividends on our common stock in the two most recent fiscal years. We have no current plans to pay dividends on our common stock. We expect to retain future earnings, if any, to fund the development and growth of our business. The declaration, amount and payment of any future dividends will be at the sole discretion of our Board of Directors. Our Board of Directors may take into account general and economic conditions, our financial condition and results of operations, our available cash and current and anticipated cash needs, capital requirements, contractual, legal, tax and regulatory restrictions and implications on the payment of dividends by us to our stockholders or by our subsidiaries to us, including restrictions under our senior secured credit facilities and other indebtedness we may incur, and such other factors as our Board of Directors may deem relevant. In addition, because we are a holding company and have no direct operations, we will only be able to pay dividends from funds we receive from our subsidiaries.

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

None.

ITEM 6. SELECTED FINANCIAL DATA

The following historical Consolidated Statements of Operations and Consolidated Balance Sheet information has been derived from our audited consolidated financial statements. The information set forth below should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and the consolidated financial statements and notes thereto included elsewhere in this document.

| | Fiscal Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2017 | 2016 | 2015 | 2014 | 2013 |
| | | (dollars in thousands, except share and per share amounts) | | | |
| Statements of Income Data: | | | | | |
| Net sales | $1,274,589 | $1,149,778 | $1,027,447 | $917,760 | $719,509 |
| Operating income | 303,239 | 220,922 | 160,115 | 179,003 | 158,626 |
| Interest expense | 11,141 | 14,619 | 15,091 | 13,887 | 20,640 |
| Loss on extinguishment of debt | — | — | — | — | 15,918 |
| Income before income taxes | 293,325 | 206,808 | 145,318 | 165,289 | 122,193 |
| Provision for income taxes | 99,796 | 76,567 | 55,930 | 63,358 | 43,957 |
| Net income | $193,529 | $130,241 | $89,388 | $101,931 | $78,236 |
| | | | | | |
| Basic income per common share | $0.99 | $0.66 | $0.46 | $0.52 | $0.40 |
| Diluted income per common share | $0.97 | $0.65 | $0.45 | $0.52 | $0.40 |
| Dividends declared and paid per common share | $— | $— | $— | $— | $— |
| Basic weighted average shares | 196,256,128 | 196,363,084 | 195,933,800 | 195,735,309 | 195,619,943 |
| Diluted weighted average shares | 198,918,417 | 199,348,707 | 198,047,453 | 197,852,932 | 196,559,084 |
| | | | | | |
| Balance Sheet Data (end of period): | | | | | |
| Cash and cash equivalents | $282,223 | $292,656 | $224,253 | $95,788 | $42,874 |
| Working capital (1) | 381,348 | 386,346 | 286,483 | 202,243 | 114,622 |
| Property, plant, and equipment, net | 326,404 | 162,232 | 115,160 | 113,863 | 85,830 |
| Total assets (2) | 848,586 | 650,350 | 512,546 | 383,167 | 254,797 |
| Total debt, including current maturities | 393,914 | 383,137 | 387,097 | 391,057 | 395,017 |
| Stockholders' equity (deficit) | 299,136 | 146,338 | 9,281 | (87,297) | (191,085) |
| | | | | | |
| Other Data: | | | | | |
| Adjusted net income (3) | $194,800 | $156,763 | $122,477 | $106,569 | $88,930 |
| Adjusted basic net income per common share (3) | $0.99 | $0.80 | $0.63 | $0.54 | $0.45 |
| Adjusted diluted net income per common share (3) | $0.98 | $0.79 | $0.62 | $0.54 | $0.45 |
| EBITDA (4) | 313,540 | 230,122 | 168,285 | 183,863 | 143,994 |
| Adjusted EBITDA (4) | 319,150 | 275,577 | 221,689 | 193,189 | 162,442 |
| Depreciation and amortization | 10,514 | 9,200 | 8,170 | 4,860 | 1,286 |
| Capital expenditures | 170,970 | 56,345 | 9,556 | 32,948 | 63,507 |

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(1) Working capital is defined as current assets, including cash and cash equivalents, minus current liabilities. As disclosed in "Recently Issued Accounting Pronouncements," the Company elected to early adopt ASU 2015-17, "Balance Sheet Classification of Deferred Taxes," as of the fourth quarter of fiscal year 2015, utilizing retrospective application as permitted. Accordingly, working capital for prior years has been reclassified to conform to the new standard.

(2) Total assets for the fiscal year ended December 31, 2014 has been reclassified to conform to the requirements of ASU 2015-17.

(3) Adjusted net income represents net income plus loss on extinguishment of debt, public offering preparation costs, litigation expenses, and an unusual, non-recurring or one-time item (provision for legal settlement), net of tax. We present adjusted net income because our management uses it as a supplemental measure in assessing our operating performance, and we believe that it is helpful to investors, securities analysts and other interested parties, in evaluating the performance of companies in our industry. We also believe adjusted net income is useful to management, investors, securities analysts and other interested parties as a measure of our comparative operating performance from period to period. Adjusted net income is not a measurement of financial performance under GAAP. It should not be considered an alternative to net income as a measure of our operating performance or any other measure of performance derived in accordance with GAAP. In addition, adjusted net income should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items. Adjusted net income has limitations as an analytical tool, and you should not consider such measure either in isolation or as a substitute for analyzing our results as reported under GAAP. Our definition and calculation of adjusted net income is not necessarily comparable to other similarly titled measures used by other companies due to different methods of calculation.

Adjusted basic net income per common share is defined as adjusted net income divided by basic weighted average shares. Adjusted diluted net income per common share is defined as adjusted net income divided by diluted weighted average shares.

The following table provides a reconciliation of net income to adjusted net income:

| | Fiscal Year Ended December 31, 2017 | | |
|---|---|---|---|
| (dollars in thousands) | Pre-Tax | Income Taxes | After-Tax |
| Net income | $293,325 | $99,796 | $193,529 |
| Litigation expenses (3a) | 1,927 | 656 | 1,271 |
| Adjusted net income | $295,252 | $100,452 | $194,800 |

| | Fiscal Year Ended December 31, 2016 | | |
|---|---|---|---|
| (dollars in thousands) | Pre-Tax | Income Taxes | After-Tax |
| Net income | $206,808 | $76,567 | $130,241 |
| Public offering preparation costs (3b) | 2,132 | — | 2,132 |
| Litigation expenses (3a) | 6,714 | 2,484 | 4,230 |
| Litigation provision (3c) | 32,000 | 11,840 | 20,160 |
| Adjusted net income | $247,654 | $90,891 | $156,763 |

| | Fiscal Year Ended December 31, 2015 | | |
|---|---|---|---|
| (dollars in thousands) | Pre-Tax | Income Taxes | After-Tax |
| Net income | $145,318 | $55,930 | $89,388 |
| Public offering preparation costs (3b) | 8,513 | 1,508 | 7,005 |
| Litigation expenses (3a) | 10,071 | 3,827 | 6,244 |
| Litigation provision (3c) | 32,000 | 12,160 | 19,840 |
| Adjusted net income | $195,902 | $73,425 | $122,477 |

| | Fiscal Year Ended December 31, 2014 | | |
|---|---|---|---|
| (dollars in thousands) | Pre-Tax | Income Taxes | After-Tax |
| Net income | $165,289 | $63,358 | $101,931 |
| Public offering preparation costs (3b) | 2,886 | 1,109 | 1,777 |
| Litigation expenses (3a) | 4,621 | 1,760 | 2,861 |
| Adjusted net income | $172,796 | $66,227 | $106,569 |

| | Fiscal Year Ended December 31, 2013 | | |
|---|---|---|---|
| (dollars in thousands) | Pre-Tax | Income Taxes | After-Tax |
| Net income | $122,193 | $43,957 | $78,236 |
| Loss on extinguishment of debt (3d) | 15,918 | 5,921 | 9,997 |
| Public offering preparation costs (3b) | 1,110 | 413 | 697 |
| Adjusted net income | $139,221 | $50,291 | $88,930 |

(3a) Represents costs, net of insurance primarily related to the litigation with Nestlé Purina.

(3b) Represents costs incurred in preparing for our public offerings and common stock issued to our employees.

(3c) Represents provision related to the settlement agreements entered into in December 2015 and November 2016, respectively for our U.S. consumer class action and Nestlé Purina lawsuits. See Note 14 to our consolidated financial statements.

(3d) Represents the loss on extinguishment of debt associated with the repricing of our senior secured credit facilities in December 2013.

(4) EBITDA represents net income plus interest expense, less interest income and plus provision for income taxes and depreciation and amortization. Adjusted EBITDA represents EBITDA plus loss on extinguishment of debt, public offering preparation costs, litigation expenses, stock-based compensation and an unusual, non-recurring or one-time item (provision for legal settlements).
We present EBITDA and Adjusted EBITDA because our management uses these as supplemental measures in assessing our operating performance, and we believe they are helpful to investors, securities analysts and other interested parties, in evaluating the performance of companies in our industry. We also believe EBITDA and Adjusted EBITDA are useful to management, investors, securities analysts and other interested parties as measures of our comparative operating performance from period to period. EBITDA and Adjusted EBITDA are not measurements of financial performance under GAAP. They should not be considered as alternatives to cash flow from operating activities, as measures of liquidity, or as alternatives to net income as a measure of our operating performance or any other measures of performance derived in accordance with GAAP. In addition, EBITDA and Adjusted EBITDA should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items. EBITDA and Adjusted EBITDA have limitations as analytical tools, and you should not consider such measures either in isolation or as substitutes for analyzing our results as reported under GAAP. Our definitions and calculations of EBITDA and Adjusted EBITDA are not necessarily comparable to other similarly titled measures used by other companies due to different methods of calculation.

The following table provides a reconciliation of net income to adjusted EBITDA:

| | Fiscal Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| (dollars in thousands) | 2017 | 2016 | 2015 | 2014 | 2013 |
| Net income | $193,529 | $130,241 | $89,388 | $101,931 | $78,236 |
| Interest expense | 11,141 | 14,619 | 15,091 | 13,887 | 20,640 |
| Interest income | (1,440) | (505) | (294) | (173) | (125) |
| Provision for income taxes | 99,796 | 76,567 | 55,930 | 63,358 | 43,957 |
| Depreciation and amortization | 10,514 | 9,200 | 8,170 | 4,860 | 1,286 |
| EBITDA | $313,540 | $230,122 | $168,285 | $183,863 | $143,994 |
| Loss on extinguishment of debt (4a) | — | — | — | — | 15,918 |
| Public offering preparation costs (4b) | — | 2,132 | 8,513 | 2,886 | 1,110 |
| Litigation expenses (4c) | 1,927 | 6,714 | 10,071 | 4,621 | — |
| Provision for legal settlements (4d) | — | 32,000 | 32,000 | — | — |
| Stock-based compensation (4e) | 3,683 | 4,609 | 3,434 | 1,820 | 1,420 |
| Adjusted EBITDA | $319,150 | $275,577 | $222,303 | $193,190 | $162,442 |

(4a) Represents the loss on extinguishment of debt associated with the repricing of our senior secured credit facilities in December 2013.
(4b) Represents costs incurred in preparing for our public offerings and common stock issued to our employees.
(4c) Represents costs primarily related to the litigation with Nestlé Purina.
(4d) Represents provisions related to the settlement agreements entered into in December 2015 and November 2016, respectively for our U.S. consumer class action and Nestlé Purina lawsuits. See Note 14 to our consolidated financial statements.
(4e) Represents non-cash, stock-based compensation expense.

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion contains forward-looking statements that reflect our plans, estimates and beliefs. Such statements involve risks and uncertainties. Our actual results may differ materially from those discussed in the forward-looking statements as a result of various factors, including, but not limited to those set forth in the "Risk Factors" section of this report. You should carefully read "Risk Factors" and "Statement Regarding Forward-Looking Disclosures". The following discussion of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes. All references to years, unless otherwise noted, refer to our fiscal years, which end on December 31.

### Overview

We are one of the fastest growing major pet food companies in the United States, selling dog and cat food made with whole meats, fruits and vegetables, and other high-quality, natural ingredients. BLUE is a billion dollar brand and is the #1 brand in the Wholesome Natural market segment. We develop, produce, market, and sell pet food under our five product lines: BLUE Life Protection Formula, BLUE Wilderness, BLUE Basics, BLUE Freedom, and BLUE Natural Veterinary Diet. Each of our major product lines of pet food include different product types for dogs and cats, such as dry food, wet food, and treats. While we have only one reporting segment, for purposes of discussing our net sales we categorize our products as (i) Dry Foods or (ii) Wet Foods, Treats, and Other Products. Dry Foods contributed approximately 80% of our net sales for 2017, with the remaining 20% attributable to Wet Foods, Treats and Other Products.

We sell our products in the specialty channels, including eCommerce, either directly to retailers or through distributors and, beginning in the third quarter of 2017, to a limited number of select grocery and mass retailers in the FDM channel in the United States. We expect to continue to expand our distribution in the FDM channel. The specialty channels include national pet superstore chains, regional pet store chains, neighborhood pet stores, veterinary clinics and hospitals, farm and feed stores, eCommerce retailers, military outlets and hardware stores. BLUE is sold across all types of specialty retailers in the United States, Canada, Mexico, and Japan, although our sales in the veterinary channel are currently minimal. Our products were first sold in national pet superstores and a majority of our net sales is still generated from national pet superstores, PetSmart and Petco, which are our top two customers. We have experienced significant growth in our net sales to eCommerce retailers, and these sales have continued to grow faster than our net sales to national pet superstores. In fact, our net sales to national pet superstores declined in 2017 primarily due to reduced traffic trends at such stores. Despite our growth within eCommerce, we expect that our sales will continue to be concentrated in a limited number of customers due to PetSmart’s acquisition of Chewy.com (a leading pet eCommerce retailer) in the second quarter of 2017. We expect that partnering with leading grocery and mass retailers in the FDM channel will allow us to reach more pet parents and feed more pets. Notwithstanding our expansion into the FDM channel, we expect to continue to work closely with our specialty retail customers as they provide an optimal environment for us to interact with and educate pet parents and as they dedicate more shelf space to pet food, which grants consumers access to a broader range of our products. Over the last three years, we have diversified our customer base, with 52% of our net sales generated from national pet superstores (excluding Chewy.com) in 2017 as compared to 70% in 2015.

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Our products are manufactured in the United States through a hybrid network of owned and contracted manufacturing facilities and distributed from owned and contracted distribution centers. In September 2014, we commenced manufacturing operations at our Joplin Dry Food Facility, which is expected to provide us with approximately half of our forecasted dry food production needs over the next several years. We are also close to completing the expansion of our internal manufacturing capabilities to provide additional dry production capacity commencing in the second half of 2018 at our Heartland Richmond Facility. The Joplin Dry Food Facility and the Heartland Richmond Facility are expected to initially provide us with approximately 60% of our dry food production needs and expand up to approximately 85% of our dry food production needs over the next several years. In addition, we recently commenced operations at our Joplin Treats Facility, which is our first treats facility and adjacent to our Joplin Dry Food Facility.

The primary market for our products is the United States, which represented approximately 96% of our net sales for 2017, 2016 and 2015, with the remaining 4%, respectively, for each of those periods attributable primarily to our operations in Canada, where we also market and sell our products. In 2017, we also had minimal net sales in Mexico, Japan and our veterinary channel. As part of our growth strategies, we intend to continue to expand our international operations to select markets.

Recent Merger Announcement

On February 22, 2018, General Mills, Inc. (“GMI”) and Blue Buffalo Pet Products, Inc. announced that they had entered into a definitive merger agreement (the “Merger Agreement”), among GMI, Blue Buffalo Pet Products, Inc. and Bravo Merger Corp. (“Merger Sub”) under which, on the terms and subject to the conditions set forth in the Merger Agreement, GMI will acquire the Company for $40.00 per common share, in cash. The transaction is expected to close in the second quarter of 2018.

In accordance with and subject to the terms of the Merger Agreement, Merger Sub will merge with and into the Registrant, with the Registrant continuing as the surviving company and as a wholly-owned subsidiary of GMI, and our common stock will be delisted from the NASDAQ Stock Market.

Completion of the Merger is subject to certain regulatory approvals and other customary closing conditions. Holders of more than 50% of the Company’s outstanding shares have approved the transaction and no other approval of the Company’s Board of Directors or shareholders is required to complete the transaction. See “Risk Factors-Risks Related to the Pending Merger” in “Part I-Item 1A. Risk Factors.”

Industry Trends

The U.S. pet food industry has been growing as a result of a number of factors, including:

- continued humanization of pets – more pet parents consider their pets to be a family member, driving demand for more premium and specialized pet foods;
- strong health and wellness trends crossing over from human foods – there is increased focus on pets consuming high-quality, natural foods, as evidenced by the growth in the Wholesome Natural market segment; and

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

- growth of eCommerce – which has resulted in the specialty channels growing faster than the FDM channel as pet parents are attracted to the variety and premium assortment offered by retailers in the specialty channels.

Nonetheless, the pet food industry faces a number of challenges and uncertainties including:

- the pet food industry's continued ability to innovate and meet pet parents' future needs;
- increased promotional activity in the pet food industry;
- despite experiencing significant growth over the past 10 years, national pet superstores recently have been experiencing significantly reduced foot traffic and increased competition from other channels, including eCommerce; and
- new or increased regulatory requirements and scrutiny, including increased oversight by the FDA and the implementation of the Food Safety Modernization Act.

Components of our Results of Operations

Net Sales

We develop, produce, market and sell natural pet food in the specialty channels in the United States, Canada, Mexico and Japan and to select grocery and mass retailers in the FDM channel in the United States. We rely on consumer demand for our products, financial performance of our products for retailers and our position in the marketplace, rather than entering into contracts with retailers to sell our products. We enter into agreements with various distributors to distribute our products to other stores in the specialty channel that typically stock a narrower range of our products given their smaller store footprints. We recognize revenues generally upon receipt of the product by the customer. See “Critical Accounting Policies and Estimates—Revenue Recognition.” All sales are made on pre-agreed pricing terms, are not subject to contingencies and are, therefore, final.

We offer a variety of trade promotions and incentives to our customers and consumers, such as temporary price reductions, cooperative advertising programs, in-store displays and coupons. These trade promotions and incentives are accounted for as a reduction of our net sales. Our net sales are periodically influenced by the timing, extent and amount of such trade promotions and incentives.

Over the past three year period, our net sales growth has been driven, in part, by our growth in net sales in national pet superstores. In addition, the following trends have also helped to drive our growth in net sales over the past three years and we expect these trends to drive our growth in net sales in the near future:

- our increased availability to a greater proportion of pet parents as we have expanded our distribution to other retailers in the specialty channels, including farm and feed stores and eCommerce retailers, and to retailers in the FDM channel;
- our continued investment in our highly-effective marketing and brand-building; and

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ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

- our continued innovation, including the expansion of existing product lines, the introduction of new product types and the introduction of new product lines that are tailored to meet evolving consumer preferences and the needs of different pets. The revenue per pound of new products that we introduce across our product lines is typically higher than the average revenue per pound of existing products in our portfolio due to their more specialized and higher cost formulas.

These factors have powered our growth at a faster rate than the overall pet food industry. Over the past three years, our net sales have increased at a CAGR of 12% as compared to the overall pet food industry which has increased at a CAGR of 4%, according to Euromonitor. While we expect these trends to continue to drive our growth for the near future, we believe that our growth rate will decline in the future as our scale increases.

However, our results of operations and business face the following challenges and uncertainties:

- our ability to introduce new product offerings that will gain broad market acceptance;
- reduced traffic trends at national pet superstores;
- competitive threats from other pet foods companies;
- our ability to pass along increases in commodity costs to our customers and ultimately to consumers; and
- reduced customer and consumer demand for our products due to a recession, financial and credit market disruptions, or other global economic downturns.

Gross Profit

Gross profit is our net sales less cost of goods sold. Our cost of goods sold consists primarily of costs of ingredients and packaging materials, manufacturing costs and costs associated with our warehouses and distribution network, which are influenced by a number of factors including transportation costs and fuel charges. These components are subject to fluctuations in certain commodities and inflation. Gross margin measures our gross profit as a percentage of net sales.

We have a network that both self manufactures finished goods as well as purchases finished products from our contract manufacturers predominantly on a cost-plus basis. We pay our contract manufacturers on a dollar-per-pound basis for dry foods and dollar-per-unit basis for wet foods and treats. Over the past three years, we have worked closely with our contract manufacturers to negotiate lower manufacturing costs through increased volume of purchases, contract consolidation and price negotiations. More recently, the value of our contract manufacturers' productivity has been somewhat offset with up-charges that are a result of smaller run sizes and more complex diets.

We negotiate pricing and availability directly with suppliers for most ingredients in our dry foods. We also negotiate for raw materials used at our Heartland Facilities as well as for contract manufacturers. Our contract manufacturers then purchase these ingredients from suppliers approved by us based on the specifications and terms we negotiate. This has allowed us to consolidate ingredient sourcing across our manufacturing network in order to negotiate more favorable pricing on ingredients for dry foods, which make up the majority of our product portfolio. For wet foods and treats, our contract manufacturers

negotiate directly with suppliers approved by us and purchase ingredients directly based on our specifications. We have entered into contracts relating to the physical purchase of the majority of the main ingredients, including our meats and meals, grains, fruit, vegetables, starches and fibers. These contracts are focused primarily on ensuring availability, quality and price predictability. Depending on the nature of the ingredients, some contracts are fixed in price while others have a variable component based on a pricing formula. The length of the contracts is fixed for a period of time, typically up to a year or for a season and/or a crop year. We have increased the percentage of ingredients contracted for our dry foods from approximately 30% of our forward twelve-month needs in 2009 to approximately 90% in 2017. In 2018, under our Commodity Price Risk Management Policy we expect to contract approximately 90% of our ingredients for our forward twelve-month needs, as well as enter into fixed price and/or fixed quantity contracts for a pre-determined amount of our ingredients to reduce short-term price volatility in certain commodities. Although we do not currently engage in hedging activities, we may adopt certain hedging strategies in the future consistent with our Commodity Price Risk Management Policy. We believe these efforts will help ensure the availability and quality of our ingredients and help mitigate the impact of volatile and increasing commodity costs on our business.

We have also invested and plan to continue to invest in equipment to be used by certain of our contract manufacturers to increase volume capacity where needed, improve efficiency and improve product quality. We have a hybrid network of owned and contracted manufacturing facilities. We believe this hybrid network will provide us with enhanced margin opportunities and greater flexibility in our supply chain. In the near term, these manufacturing efficiencies will give us an opportunity to reinvest in growth initiatives, including the flexibility to respond to competitive activity.

Over the past three years, despite volatility in commodity prices and start-up costs associated with our Joplin Dry Food Facility in 2014 and our Joplin Treats Facility and Heartland Richmond Facility in 2017, we have managed our gross margin through a combination of increased prices to offset commodity cost inflation, changes in our product mix, productivity improvements, purchasing efficiencies and cost reductions in our supply chain. Historically, we have been able to pass along commodity cost increases to our customers through annual or semiannual price increases. When evaluating pricing, we consider many factors including cost of sales increases, competitive pricing strategy and the price-value equation to our consumers. In 2017, we raised prices on selected items to offset certain commodity cost increases. This resulted in a blended price increase of approximately 2% which we believe did not materially impact our sales volumes.

Selling, General and Administrative Expenses

Our selling, general and administrative expenses primarily consist of advertising and marketing expenses, salaries and other payroll-related expenses, stock-based compensation, legal and professional fees, consulting expenses, travel expenses, depreciation and research and development costs. Selling, general and administrative expenses as a percentage of net sales has increased from 22.1% in 2015 to 22.4% in 2017, primarily driven by increased investments in advertising to support new product releases and drive greater brand awareness, investments in our strategic initiatives, and investments in our corporate infrastructure to support our large scale and growth.

In the future, we expect our selling, general and administrative expenses to grow at a slower rate than our net sales growth as we leverage our past investments. In the near term, we intend to reinvest operating efficiencies to fund our growth initiatives.

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Results of Operations

The following table presents selected statement of income data expressed as a percentage of net sales:

| | Fiscal Year Ended December 31, | | | % of Net Sales | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | 2017 | 2016 | 2015 | 2017 | 2016 | 2015 |
| Net sales | $1,274,589 | $1,149,778 | $1,027,447 | 100.0 % | 100.0% | 100.0% |
| Cost of sales | 685,501 | 634,095 | 608,616 | 53.8 % | 55.1 % | 59.2 % |
| Gross profit | 589,088 | 515,683 | 418,831 | 46.2 % | 44.9 % | 40.8 % |
| Selling, general, and administrative expenses | 285,849 | 262,761 | 226,716 | 22.4 % | 22.9 % | 22.1 % |
| Provision for legal settlement | — | 32,000 | 32,000 | — % | 2.8 % | 3.1 % |
| Operating income | 303,239 | 220,922 | 160,115 | 23.8 % | 19.2 % | 15.6 % |
| Interest expense | 11,141 | 14,619 | 15,091 | 0.9 % | 1.3 % | 1.5 % |
| Interest income | (1,440) | (505) | (294) | (0.1)% | — % | — % |
| Other non-operating expense, net | 213 | — | — | — % | — % | — % |
| Income before income taxes | 293,325 | 206,808 | 145,318 | 23.0 % | 18.0 % | 14.1 % |
| Provision for income taxes | 99,796 | 76,567 | 55,930 | 7.8 % | 6.7 % | 5.4 % |
| Net income | $193,529 | $130,241 | $89,388 | 15.2 % | 11.3 % | 8.7 % |
| Basic net income per common share | $0.99 | $0.66 | $0.46 | | | |
| Diluted net income per common share | $0.97 | $0.65 | $0.45 | | | |

Year Ended December 31, 2017 Compared With Year Ended December 31, 2016

Net Sales

Net sales increased $124.8 million, or 10.9%, to $1,274.6 million for the year ended December 31, 2017, compared to $1,149.8 million for the year ended December 31, 2016. Volume growth accounted for 6.1 percentage points of the increase in net sales, favorable product mix contributed 4.5 percentage points, and favorable net pricing contributed 0.3 percentage point.

Net sales of Dry Foods increased $79.3 million, or 8.5%, to $1,013.5 million for the year ended December 31, 2017, compared to $934.2 million for the year ended December 31, 2016. Volume growth accounted for 5.1 percentage points of the increase in net sales of Dry Foods, favorable product mix contributed 2.0 percentage point of growth, and favorable net pricing contributed 1.4 percentage points. The strong performance of our BLUE Life Protection Formula and BLUE Wilderness product lines drove the growth in net sales of Dry Foods. The increase in net pricing was primarily driven by pricing actions taken on selected items during the first quarter of 2017.

Net Sales of Wet Foods, Treats and Other Products increased $45.5 million, or 21.1%, to $261.1 million for the year ended December 31, 2017, compared to $215.6 million for the year ended December 31, 2016. Favorable product mix accounted for 15.5 percentage points of the increase in net sales of Wet Foods, Treats and Other Products, volume growth contributed 10.2 percentage points of growth, which was partially offset by unfavorable net pricing of 4.6 percentage points. The strong performance of our

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

BLUE Life Protection Formula and BLUE Wilderness product lines drove the growth in net sales of Wet Foods, Treats and Other Products. The decrease in net pricing was primarily driven by an increase in promotional activity.

Gross Profit

Gross profit increased $73.4 million, or 14.2%, to $589.1 million for the year ended December 31, 2017, compared to $515.7 million for the year ended December 31, 2016, driven primarily by increased volume. Gross margin increased to 46.2% for the year ended December 31, 2017, from 44.9% for the year ended December 31, 2016, driven primarily by supply chain efficiencies including lower input costs and favorable product mix.

Selling, General, and Administrative Expenses

Selling, general, and administrative expenses were $285.8 million for the year ended December 31, 2017, an increase of $23.1 million, or 8.8%, from $262.8 million for the year ended December 31, 2016. The increase is primarily due to incremental expense related to ongoing investment in advertising and marketing consistent with our strategy to invest in our brand and product lines.

Provision for Legal Settlement

There was no provision for legal settlement for the year ended December 31, 2017. Provision for legal settlement for the year ended December 31, 2016 was $32.0 million due to the settlement agreement entered into on November 2, 2016 related to the Nestlé Purina lawsuit. The legal settlement is disclosed in Note 14 to our consolidated financial statements.

Interest Expense

Interest expense decreased $3.5 million, or 23.8%, to $11.1 million for the year ended December 31, 2017, compared to $14.6 million for the year ended December 31, 2016. The decrease was primarily driven by an increase in capitalized interest expense. The capitalized interest expense related to the expansion of our internal manufacturing capabilities.

Interest Income

Interest income increased $0.9 million, or 185.1%, to $1.4 million for the year ended December 31, 2017, compared to $0.5 million for the year ended December 31, 2016. This increase was driven by higher interest rates on interest bearing demand deposit accounts.

Provision for Income Taxes

Provision for income taxes increased $23.2 million, or 30.3%, to $99.8 million for the year ended December 31, 2017, compared to $76.6 million for the year ended December 31, 2016. Our effective tax rate was 34.0% for the year ended December 31, 2017 as compared to 37.0% for the year ended December 31, 2016. The decrease in the effective rate was primarily due to the effects of stock option exercises and impact from The Tax Cuts and Job Act of 2017.

Net Income

As a result of the factors above, net income increased $63.3 million, or 48.6%, to $193.5 million for the year ended December 31, 2017, compared to $130.2 million for the year ended December 31, 2016.

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Year Ended December 31, 2016 Compared With Year Ended December 31, 2015

Net Sales

Net sales increased $122.3 million, or 11.9%, to $1,149.8 million for the year ended December 31, 2016, compared to $1,027.5 million for the year ended December 31, 2015. Volume growth accounted for 8.9 percentage points of the increase in net sales, favorable net pricing of 1.6 percentage points, and a favorable product mix contributed 1.4 percentage points.

Net sales of Dry Foods increased $100.2 million, or 12.0%, to $934.2 million for the year ended December 31, 2016, compared to $834.1 million for the year ended December 31, 2015. Volume growth accounted for 9.2 percentage points of the increase in net sales of Dry Foods, favorable net pricing contributed 2.1 percentage points, and favorable product mix contributed 0.7 percentage point of growth. The strong performance of our BLUE Wilderness, BLUE Life Protection Formula, and BLUE Freedom lines drove the growth in net sales of Dry Foods. The increase in net pricing was primarily driven by pricing actions taken on selected items during the first quarter of 2016.

Net Sales of Wet Foods, Treats and Other Products increased $22.1 million, or 11.5%, to $215.6 million for the year ended December 31, 2016, compared to $193.4 million for the year ended December 31, 2015. Volume growth accounted for 7.3 percentage points of the increase in net sales of Wet Foods, Treats and Other Products, favorable product mix contributed 4.5 percentage point of growth, which was partially offset by unfavorable net pricing of 0.3 percentage points. The strong performance of our BLUE Wilderness and BLUE Life Protection Formula lines drove the growth in net sales of Wet Foods, Treats and Other Products.

Gross Profit

Gross profit increased $96.9 million, or 23.1%, to $515.7 million for the year ended December 31, 2016, compared to $418.8 million for the year ended December 31, 2015, driven primarily by increased volume. Gross margin increased to 44.9% for the year ended December 31, 2016, from 40.8% for the year ended December 31, 2015, driven primarily by supply chain efficiencies including lower input costs and higher net price realization.

Selling, General, and Administrative Expenses

Selling, general, and administrative expenses were $262.8 million for the year ended December 31, 2016, up $36.0 million, or 15.9%, from $226.7 million for the year ended December 31, 2015. The increase reflects $32.5 million of incremental expense related to ongoing investment in advertising and marketing ($17.7 million) consistent with our strategy to invest in our brand and product lines and investments made in strategic initiatives ($14.8 million).

Provision for Legal Settlement

Provision for legal settlement for the year ended December 31, 2016 was $32.0 million due to the settlement agreement entered into on November 2, 2016 related to the Nestlé Purina lawsuit. The provision for legal settlement for the year ended December 31, 2015 related to our U.S. class action lawsuits. Both legal settlements are disclosed in Note 14 to our consolidated financial statements.

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Interest Expense

Interest expense decreased $0.5 million, or 3.1%, to $14.6 million for the year ended December 31, 2016, compared to $15.1 million for the year ended December 31, 2015. The decrease was driven by a decrease in our effective interest rate for fiscal 2016 of 3.79% compared to 3.87% in the prior year.

Interest Income

Interest income increased $0.2 million or 71.8%, to $0.5 million for the year ended December 31, 2016, compared to $0.3 million for the year ended December 31, 2015. This increase was driven by higher average cash on hand for 2016 as compared to 2015.

Provision for Income Taxes

Provision for income taxes increased $20.6 million, or 36.9%, to $76.6 million for the year ended December 31, 2016, compared to $55.9 million for the year ended December 31, 2015. Our effective tax rate was 37.0% for the year ended December 31, 2016 as compared to 38.5% for the year ended December 31, 2015. The decrease in the effective rate was due to non-deductible permanent differences primarily related to the close of our initial public offering in the prior year.

Net Income

As a result of the factors above, net income increased $40.9 million, or 45.7%, to $130.2 million for the year ended December 31, 2016, compared to $89.4 million for the year ended December 31, 2015.

Financial Condition, Liquidity, and Capital Resources

Overview

Historically, our primary source of liquidity has been cash flow from operations. In addition, we also have a $120.0 million Revolving Facility to provide us with an additional source of liquidity but have not had to draw on our Revolving Facility. As of December 31, 2017, our cash and cash equivalents were $282.2 million compared to cash and cash equivalents as of December 31, 2016 of $292.7 million. On May 25, 2017, we entered into a new $400.0 million term facility (the "Term Facility"). A majority of the proceeds of the Term Facility were used to refinance the Old Credit Agreement (as defined below). As of December 31, 2017, we had outstanding indebtedness of $398.0 million under the term loan facilities. Pursuant to the Credit Agreement (as defined below), $1.0 million of the Term Facility must be repaid each fiscal quarter which commenced with the fiscal quarter of the Company ending September 30, 2017. Upon maturity on May 25, 2024, the remaining principal balance of $373.0 million will be due. Our primary cash needs are for capital expenditures and working capital. Capital expenditures typically vary depending on the timing of infrastructure-related investments. We plan to make capital expenditures of approximately $90.0 million to $110.0 million in fiscal 2018, which we expect to fund from cash generated from operations. We expect the majority of expenditures in fiscal 2018 will be used to fund our multi-year program to expand our internal manufacturing capabilities.

Our primary working capital requirements are for product and product-related costs, the payment of payroll, rent and distribution costs, advertising and marketing expenditures and the costs related to the development and commercialization of new products. Fluctuations in working capital are primarily driven by fluctuations in accounts receivable. As of December 31, 2017, we had working capital of $381.3 million, compared to $386.3 million as of December 31, 2016.

On July 31, 2017, the Board of Directors approved the terms of a share repurchase program, under which the Company is authorized to repurchase up to $50.0 million of its common shares. The Company financed the $50.0 million share repurchase program through its cash generated from operations and cash on hand. Based on the Company’s strong cash flow and balance sheet, this program did not impact our ability to execute our business plans, allocate capital for our capital investment projects or pursue other strategic initiatives. We completed this share repurchase program in August 2017.

We believe that our operating cash flow and cash on hand will be adequate to meet our operating, investing and financing needs for the foreseeable future. If necessary, we can borrow funds under our revolving credit facility to finance our liquidity requirements, subject to customary borrowing conditions. To the extent additional funds are necessary to meet our long-term liquidity needs as we continue to execute our business strategy, we anticipate that they will be obtained through the incurrence of additional indebtedness, additional equity financings or a combination of these potential sources of funds. Our ability to meet our operating, investing and financing needs depend to a significant extent on our future financial performance, which will be subject in part to general economic, competitive, financial, regulatory and other factors that are beyond our control, described in the “Risk Factors” section of this Annual Report on Form 10-K for the year ended December 31, 2017. In addition to these general economic and industry factors, the principal factors in determining whether our cash flows will be sufficient to meet our liquidity requirements will be our ability to provide attractive products to our customers and consumers, increase prices to offset higher commodity costs, manage production and our supply chain and improve our productivity. In the event that we need access to additional cash, we may not be able to access the credit markets on commercially acceptable terms or at all. We may need to refinance all or a portion of the principal amounts outstanding under our term loan facilities on or before May 25, 2024. We expect to continually assess our performance, the economic environment and market conditions to guide our decisions regarding our uses of cash, including capital expenditures.

Cash Flows

Cash Provided by Operating Activities

Net cash provided by operating activities was $193.9 million for the year ended December 31, 2017, compared to $127.2 million for the year ended December 31, 2016. The increases in net cash provided by operating activities was primarily driven by increased earnings and the absence of $64.0 million of payments related to settlement agreements in our U.S. consumer class action and Nestlé Purina lawsuits that occurred in the prior year.

Net cash provided by operating activities was $127.2 million for the year ended December 31, 2016, compared to $138.2 million for the year ended December 31, 2015. The decreases in net cash provided by operating activities was primarily driven by $64.0 million of payments related to settlement agreements in our U.S. consumer class action and Nestlé Purina lawsuits and unfavorable changes in accounts receivable. The decrease in net cash provided by operating activities was partially offset by an increase in earnings over the prior comparative period.

Cash Used in Investing Activities

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

Net cash used in investing activities was $171.0 million for the year ended December 31, 2017, compared to $56.6 million for the year ended December 31, 2016. The increase in net cash used in investing activities was primarily driven by capital expenditures for investments made in our three-year program to expand our internal manufacturing capabilities.

Net cash used in investing activities was $56.6 million for the year ended December 31, 2016, compared to $9.6 million for the year ended December 31, 2015. The increase in net cash used in investing activities was primarily driven by capital expenditures for investments made in our three-year program to expand our internal manufacturing capabilities.

Cash Used in Financing Activities

For the year ended December 31, 2017, net cash used in financing activities was $33.5 million, compared to $2.0 million for the year ended December 31, 2016. The increase in net cash used in financing activities was primarily due to repurchases of common stock, which was partially offset by proceeds received from the issuance of new debt and the exercise of stock options.

For the year ended December 31, 2016, net cash used in financing activities was $2.0 million, compared to $0.2 million for the year ended December 31, 2015. The increase in net cash used in financing activities was due to the effects of the early adoption of ASU 2016-09 in the third quarter of 2016 to recognize excess tax benefits from the exercise of stock options within operating activities only. This early adoption was applied prospectively to the statement of cash flows.

Description of Indebtedness

As of December 31, 2017, our Term Facility consisted of $398.0 million of outstanding term loans maturing on May 25, 2024, and an undrawn $120.0 million Revolving Facility (which includes borrowing capacity available for letters of credit and for short-term borrowings) maturing on May 25, 2022. As of December 31, 2017, the interest rate on the term loan facilities was 3.57%.

All obligations under the Credit Agreement are guaranteed by each of the material wholly-owned domestic restricted subsidiaries of the Company, subject to certain exceptions. All obligations under the Credit Agreement, and the guarantees of those obligations, are secured by substantially all of the assets of the Company and each guarantor, subject to customary exceptions, including:

- a pledge of 100% of the equity interests directly held by the Company and each guarantor in any wholly-owned material subsidiary of the Company or any guarantor (which pledge, in the case of any non-U.S. subsidiary or FSHCO, will not include more than 65% of the voting stock of such non-U.S. subsidiary or FSHCO), subject to certain exceptions; and
- a security interest in substantially all of the tangible and intangible assets of the Company and each guarantor, subject to customary exceptions.

The Credit Agreement contains other customary terms, including (i) representations and warranties, (ii) affirmative covenants, (iii) negative covenants, including limitations on indebtedness, liens, mergers, acquisitions, asset sales, investments, distributions, prepayments of subordinated debt, and transactions with affiliates, in each case subject to baskets, thresholds and other exceptions, and a financial covenant to maintain a certain Consolidated First Lien Net Leverage Ratio as set forth in the Credit Agreement, and (iv) customary events of default. The Company believes it was in compliance with its financial debt covenants in the credit agreement as of December 31, 2017.

Contractual Obligations and Commitments

The following table summarizes our contractual obligations as of December 31, 2017:

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| (dollars in thousands) | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More than 5 Years |
| Long-term debt (1) | $398,000 | $4,000 | $12,000 | $8,000 | $374,000 |
| Interest on debt (2) | 88,198 | 14,194 | 41,645 | 27,024 | 5,335 |
| Operating lease obligations | 35,857 | 6,843 | 17,828 | 8,864 | 2,322 |
| Capital lease obligations | 102 | 58 | 44 | — | — |
| Finished goods minimum purchase obligations (3) | 15,863 | 13,596 | 2,267 | — | — |
| Raw material purchase obligations | 456,909 | 333,789 | 123,120 | — | — |
| Total contractual obligations | $994,987 | $372,479 | $196,963 | $43,888 | $381,657 |

(1) Does not reflect any excess cash flow payments.

(2) Reflects interest expense calculated using the interest rate on the term loan facilities as of December 31, 2017 of 3.57%.

(3) Reflects our estimate of the minimum co-manufacturer production commitments.

Off Balance Sheet Arrangements

During 2013, Heartland Pet Foods Manufacturing Inc., our wholly-owned subsidiary, or Heartland, and Jasper County, Missouri, or Jasper, entered into an agreement pursuant to which Jasper agreed to issue up to an aggregate principal amount of $55 million of industrial revenue bonds to purchase manufacturing equipment from Heartland, which will then be leased back to Heartland. As Heartland will become the owner of the equipment at the end of the lease term, the lease meets the requirements of a capital lease and the equipment is recorded as property, plant, and equipment on our balance sheet. The Company has the right and intends to set-off any obligation to make payments under the lease agreements with the proceeds due from the industrial revenue bonds. As of December 31, 2017 and 2016, Jasper had issued, and Heartland had purchased, $55 million of industrial revenue bonds and Jasper had purchased from, and leased back to, Heartland certain manufacturing equipment for a corresponding amount.

In August 2016, Heartland and the City of Joplin, Missouri, or Joplin, entered into agreements by which Joplin agreed to issue up to an aggregate principal amount of approximately $83.3 million of industrial revenue bonds to purchase from Heartland the land on which Jopin Dry Food Facility resides and the land on which the Joplin Treats Facility would come to reside, and the associated buildings, structures, and fixtures, including the additional manufacturing equipment included in the Joplin Treats Facility (collectively, the “Property”), which will then be leased back to Heartland. As Heartland will become the owner of the Property at the end of the lease term, the lease meets the requirements of a capital lease and the equipment and land are recorded as property, plant and equipment our balance sheet. The

Company has the right and intends to set-off any obligation to make payments under the lease agreement with the amounts due under the industrial revenue bonds. As of December 31, 2017 and 2016, Joplin had issued and Heartland had purchased approximately $31.9 million and $10.8 million, respectively, of industrial revenue bonds and Joplin had purchased from, and leased back to, Heartland certain Property for a corresponding amount.

Critical Accounting Policies and Estimates

Our consolidated financial statements have been prepared in accordance with GAAP. The preparation of our financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. We base our estimates on historical experience and on various other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions. While our significant accounting policies are more fully described in the notes to our consolidated financial statements, we believe that the following accounting policies and estimates are critical to our business operations and understanding of our financial results.

Revenue Recognition

We recognize revenues when persuasive evidence of an arrangement exists, the product has been shipped, when title passes, when all risks and rewards of ownership have transferred, the sales price is fixed or determinable, and collectability is reasonably assured. In most cases, revenue recognition does not occur until the product has reached the specified customer.

In the normal course of business, we use trade promotions to support our business. Trade promotions, consisting primarily of temporary price reductions, consumer coupons, product placement fees, advertising allowances and other rebates are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized at the later of the date on which the Company recognizes the related revenue or the date on which the Company offers the incentive. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included in other current liabilities on the consolidated balance sheets.

We also maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make payments and other actual and estimated deductions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, an additional allowance could be required. Past due balances are reviewed individually for collectability. Account balances are charged off against the allowance when we believe it is probable the receivable will not be recovered.

Inventories

We provide reserves for estimated obsolescence based on specific identification. If assumptions about future demand change or actual market conditions are less favorable than those projected by management, we may require additional reserves.

Loss Contingencies

We record accruals for various contingencies including legal exposures as they arise in the normal course of business. We determine whether to disclose and accrue for loss contingencies based on an assessment of whether the risk of loss is remote, reasonably possible, or probable. Our assessment is developed in consultation with our internal and external counsel and other advisors and is based on an analysis of possible outcomes under various strategies. Loss contingency assumptions involve judgments that are inherently subjective and can involve matters that are in litigation, which, by its nature is unpredictable. We believe that our assessment of the probability of loss contingencies is reasonable, but because of the subjectivity involved and the unpredictable nature of the subject matter at issue, our assessment may prove ultimately to be incorrect, which could materially impact our consolidated financial statements.

Accounting for Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our actual current tax exposure (state, federal and foreign). We assess our income tax positions and record tax benefits for all years subject to examination based upon management’s evaluation of the facts, circumstances and information available at the reporting dates. We determine whether it is “more likely than not” that a tax position will be sustained upon the examination by the appropriate taxing authorities before any part of the benefit can be recorded in the financial statements. For those income tax positions where it is not “more likely than not” that a tax benefit will be sustained, no tax benefit has been recognized in the financial statements. Where applicable, associated interest and penalties are also recognized.

We also assess permanent and temporary differences resulting from differing bases and treatment of items for tax and accounting purposes, such as the deductibility of expenses, depreciation of property, plant and equipment, stock-based compensation expense and valuation of inventories. Temporary differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We must then assess the likelihood that our deferred tax assets will be realized from future taxable income. Actual results could differ from this assessment if sufficient taxable income is not generated in future periods. To the extent we determine the need to establish a valuation allowance or increase such allowance in a period, we must include an expense within the tax provision in the accompanying consolidated statements of operations.

Stock-based Compensation

We recognize stock-based compensation expense for our share-based payments based on the fair value of the awards at the grant date. The fair value of our stock option grants is determined using the Black-Scholes option pricing model. The fair value of restricted stock awards is determined using the closing price of the Company's common stock on the date of grant. Stock-based compensation expense is recognized on a straight-line basis over the vesting period of the stock-based award.

Effective with our initial public offering, the Company bases its common stock value on quoted market prices. The expected volatility assumption is based on the combination of the Company's historical volatility and selected companies from its peer group. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury implied yield at the date of grant. The weighted-average expected term is determined with reference to historical exercise and post-vesting cancellation experience, and the vesting period and contractual term of the awards. Upon early adopting ASU 2016-09, the Company elected to change its accounting policy to record forfeitures as they occur rather than based on an estimate from historical experience and expected future activity.

New Accounting Standards

ITEM 7. BLUE BUFFALO PET PRODUCTS, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)

See Note 2 to the consolidated financial statements for information concerning new accounting standards and the impact of the implementation of these standards on our consolidated financial statements.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We are exposed to certain market risks arising from transactions in the normal course of our business. Such risk is principally associated with interest rates and commodity price fluctuations. We currently do not enter into derivatives or other financial instruments for trading or speculative purposes.

### Interest Rate Risk

We are exposed to changes in interest rates because the indebtedness incurred under our senior secured credit facilities is variable rate debt. Interest rate changes generally do not affect the market value of our senior secured credit facilities but do affect the amount of our interest payments and, therefore, our future earnings and cash flows. At December 31, 2017, we had variable rate debt of approximately $398 million under our senior secured credit facilities. An increase of 1% would have increased our interest expense for the year ended December 31, 2017 by approximately $4 million.

### Commodity Price Risk

We use raw materials that are subject to price volatility caused by supply conditions, weather, political and economic variables and other unpredictable factors. We purchase some of our raw materials in the open market. We manage our raw material exposures by entering into contracts for our dry food ingredients and through ongoing productivity initiatives. In 2018, under our Commodity Price Risk Management Policy, we expect to contract approximately 90% of our ingredients for our forward twelve-month needs, as well as enter into fixed price and/or fixed quantity contracts for a pre-determined amount of our ingredients to reduce short term price volatility in certain commodities. Although we do not currently engage in hedging activities, we may adopt certain hedging strategies in the future consistent with our Commodity Price Risk Management Policy. If commodity price changes result in unexpected increases in raw materials, we may not be able to increase our prices to offset these increased costs without suffering reduced volume, net sales and operating results.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
Blue Buffalo Pet Products, Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Blue Buffalo Pet Products, Inc. and subsidiaries (the Company) as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity (deficit), and cash flows for each of the years in the three year period ended December 31, 2017, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2017, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 26, 2018 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ KPMG LLP

We have served as the Company's auditor since 2012.
Stamford, Connecticut
February 26, 2018

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Stockholders and Board of Directors
Blue Buffalo Pet Products, Inc.:

Opinion on Internal Control Over Financial Reporting

We have audited Blue Buffalo Pet Products, Inc. and subsidiaries' (the Company) internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2017, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2017 and 2016, the related consolidated statements of income, comprehensive income, changes in stockholders' equity (deficit), and cash flows for each of the years in the three-year period ended December 31, 2017, and the related notes (collectively, the consolidated financial statements), and our report dated February 26, 2018 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Stamford, Connecticut
February 26, 2018

Blue Buffalo Pet Products, Inc.
Consolidated Balance Sheets
(dollars in thousands, except for share data)

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 282,223 | $ 292,656 |
| Receivables, net | 150,260 | 115,446 |
| Inventories | 79,945 | 70,941 |
| Prepaid expenses and other current assets | 7,893 | 6,130 |
| Total current assets | 520,321 | 485,173 |
| Restricted cash | 781 | 781 |
| Property, plant, and equipment, net | 326,404 | 162,232 |
| Deferred income taxes | 52 | 1,311 |
| Other assets | 1,028 | 853 |
| Total assets | $ 848,586 | $ 650,350 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current maturities of long-term debt | $ 4,000 | $ 3,960 |
| Accounts payable | 63,979 | 35,238 |
| Other current liabilities | 70,994 | 59,629 |
| Total current liabilities | 138,973 | 98,827 |
| Long-term debt | 389,914 | 379,177 |
| Deferred income taxes | 7,095 | 12,660 |
| Other long-term liabilities | 13,468 | 13,348 |
| Total liabilities | 549,450 | 504,012 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock; $0.01 par value; 150,000,000 shares authorized; none issued or outstanding at December 31, 2017 and December 31, 2016 | — | — |
| Common stock, voting; $0.01 par value; 1,500,000,000 shares authorized; 197,615,064 and 196,524,010 shares issued at December 31, 2017 and December 31, 2016, respectively | 1,976 | 1,965 |
| Additional paid-in capital | 81,113 | 71,420 |
| Retained earnings | 266,221 | 72,692 |
| Accumulated other comprehensive income (loss) | (174 ) | 261 |
| Treasury stock, at cost: 2,092,774 and no shares at December 31, 2017 and December 31, 2016, respectively | (50,000 ) | — |
| Total stockholders' equity | 299,136 | 146,338 |
| Total liabilities and stockholders' equity | $ 848,586 | $ 650,350 |

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

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Blue Buffalo Pet Products, Inc.
Consolidated Statements of Income
(dollars in thousands, except for share data)

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Net sales | $1,274,589 | $1,149,778 | $1,027,447 |
| Cost of sales | 685,501 | 634,095 | 608,616 |
| Gross profit | 589,088 | 515,683 | 418,831 |
| Selling, general, and administrative expenses | 285,849 | 262,761 | 226,716 |
| Provision for legal settlement | — | 32,000 | 32,000 |
| Operating income | 303,239 | 220,922 | 160,115 |
| Interest expense | 11,141 | 14,619 | 15,091 |
| Interest income | (1,440) | (505) | (294) |
| Other non-operating expense, net | 213 | — | — |
| Income before income taxes | 293,325 | 206,808 | 145,318 |
| Provision for income taxes | 99,796 | 76,567 | 55,930 |
| Net income | $193,529 | $130,241 | $89,388 |
| Basic net income per common share | $0.99 | $0.66 | $0.46 |
| Diluted net income per common share | $0.97 | $0.65 | $0.45 |
| Basic weighted average shares | 196,256,128 | 196,363,084 | 195,933,800 |
| Diluted weighted average shares | 198,918,417 | 199,348,746 | 198,047,453 |

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

Blue Buffalo Pet Products, Inc.
Consolidated Statements of Comprehensive Income
(dollars in thousands)

| | Year Ended December 31, | | |
| --- | --- | --- | --- |
| | 2017 | 2016 | 2015 |
| Net income | $193,529 | $130,241 | $89,388 |
| Other comprehensive income (loss): | | | |
| Foreign currency translation adjustment | (435) | 292 | (31) |
| Other comprehensive income (loss), before tax | (435) | 292 | (31) |
| Income tax expense on other comprehensive income (loss) | — | — | — |
| Other comprehensive income (loss), net of tax | (435) | 292 | (31) |
| Comprehensive income | $193,094 | $130,533 | $89,357 |

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

Blue Buffalo Pet Products, Inc.
Consolidated Statement of Changes in Stockholders' Equity (Deficit)
(dollars in thousands, except for share data)

| | Common Stock | | | | | Treasury Stock | | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Additional paid-in capital | (Accumulated deficit) retained earnings | Accumulated other comprehensive income (loss) | Shares | Amount | Total |
| Balance at December 31, 2014 | 195,743,154 | $ 1,957 | $ 57,683 | $ (146,937 ) | $ — | — | $— | $ (87,297 ) |
| Other comprehensive loss | — | — | — | — | (31 ) | — | — | (31 ) |
| Exercise of stock options | 396,010 | 5 | 2,246 | — | — | — | — | 2,251 |
| Income tax benefit from exercise of stock options | — | — | 1,536 | — | — | — | — | 1,536 |
| Issuance of restricted stock | 46,750 | — | 935 | — | — | — | — | 935 |
| Issuance of common stock | 30,682 | — | 614 | — | — | — | — | 614 |
| Stock-based compensation expense | — | — | 1,885 | — | — | — | — | 1,885 |
| Net income | — | — | — | 89,388 | — | — | — | 89,388 |
| Balance at December 31, 2015 | 196,216,596 | $ 1,962 | $ 64,899 | $ (57,549 ) | $ (31 ) | — | $— | $ 9,281 |
| Other comprehensive loss | — | — | — | — | 292 | — | — | 292 |
| Exercise of stock options | 275,543 | 3 | 1,912 | — | — | — | — | 1,915 |
| Issuance of restricted stock awards | 31,871 | — | 814 | — | — | — | — | 814 |
| Stock-based compensation expense | — | — | 3,795 | — | — | — | — | 3,795 |
| Net income | — | — | — | 130,241 | — | — | — | 130,241 |
| Balance at December 31, 2016 | 196,524,010 | $ 1,965 | $ 71,420 | $ 72,692 | $ 261 | — | $— | $ 146,338 |
| Other comprehensive loss | — | — | — | — | (435 ) | — | — | (435 ) |
| Exercise of stock options | 1,055,624 | 11 | 6,010 | — | — | — | — | 6,021 |
| Issuance of restricted stock awards | 35,430 | — | 815 | — | — | — | — | 815 |
| Repurchases of common stock | — | — | — | — | — | 2,092,774 | (50,000 ) | (50,000 ) |
| Stock-based compensation expense | — | — | 2,868 | — | — | | | 2,868 |
| Net income | — | — | — | 193,529 | — | | | 193,529 |
| Balance at December 31, 2017 | 197,615,064 | $ 1,976 | $ 81,113 | $ 266,221 | $ (174 ) | 2,092,774 | $ (50,000) | $ 299,136 |

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

Blue Buffalo Pet Products, Inc.
Consolidated Statements of Cash Flows
(dollars in thousands)

| | Year Ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| Cash flows from operating activities: | | | |
| Net income | $193,529 | $130,241 | $89,388 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Depreciation and amortization | 10,514 | 9,200 | 8,170 |
| Amortization of debt issuance costs | 354 | 122 | 122 |
| Stock-based compensation | 3,683 | 4,609 | 3,434 |
| Deferred compensation | — | — | 19 |
| Loss on disposal of fixed assets | 593 | 49 | 89 |
| Deferred income taxes | (4,306) | 11,988 | (12,071) |
| Income tax benefit from exercise of stock options | — | — | (1,536) |
| Provision for class action legal settlement | — | — | 32,000 |
| Payment for class action legal settlement | — | (32,000) | — |
| Effect of changes in operating assets and liabilities: | | | |
| Receivables | (33,611) | (35,509) | (1,487) |
| Inventories | (8,930) | 12,493 | 5,140 |
| Prepaid expenses and other assets | (1,928) | (2,109) | (1,189) |
| Accounts payable | 27,995 | 4,563 | (1,733) |
| Other liabilities | 5,966 | 23,596 | 17,873 |
| Net cash provided by operating activities | 193,859 | 127,243 | 138,219 |
| Cash flows from investing activities: | | | |
| Capital expenditures | (170,970) | (56,345) | (9,556) |
| Restricted cash | — | (308) | — |
| Proceeds from the sale of fixed assets | — | 15 | — |
| Net cash used in investing activities | (170,970) | (56,638) | (9,556) |
| Cash flows from financing activities: | | | |
| Proceeds from issuance of debt | 400,000 | — | — |
| Repayment of long-term debt | (382,147) | — | — |
| Repurchase of common stock | (50,000) | — | — |
| Payment of debt issuance costs | (4,352) | — | — |
| Principal payments on long-term debt | (2,990) | (3,960) | (3,960) |
| Income tax benefit from exercise of stock options | — | — | 1,536 |
| Proceeds from exercise of stock options | 6,021 | 1,915 | 2,251 |
| Net cash used in financing activities | (33,468) | (2,045) | (173) |
| Effect of exchange rate changes on cash and cash equivalents | 146 | (157) | (25) |
| Net (decrease) increase in cash and cash equivalents | (10,433) | 68,403 | 128,465 |
| Cash and cash equivalents at beginning of period | 292,656 | 224,253 | 95,788 |
| Cash and cash equivalents at end of period | $282,223 | $292,656 | $224,253 |
| | | | |
| Supplemental schedule of non-cash investing activities: | | | |
| Accruals related to property, plant and equipment | 5,411 | — | — |

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

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Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements

Note 1 – The Company

Blue Buffalo Pet Products, Inc. (“BBPP”, and together with its subsidiaries, the “Company,” “we,” “us,” “its,” and “our”) was incorporated in the state of Delaware in July 2012 and conducts its business exclusively through its wholly-owned operating subsidiary, Blue Buffalo Company, Ltd. (“Blue”) (formerly The Blue Buffalo Company, LLC) and its subsidiaries. Blue was formed in August 2002, and is the parent company of six wholly-owned subsidiaries: Great Plains Leasing, LLC, Heartland Pet Food Manufacturing Holding, LLC, Sierra Pet Products, LLC, Blue Buffalo Pet Products Canada, Ltd., Blue Buffalo Japan Kabushiki Kaisha, and Blue Buffalo Pet Food Co., Ltd. Additionally, Blue Buffalo Import Mexico, S. de R.L. de C.V., Blue Buffalo Mexico, S. de R.L. de C.V., Heartland Pet Food Manufacturing, Inc. and Heartland Pet Food Manufacturing Indiana, LLC are indirect wholly-owned subsidiaries of BBPP. BBPP and its subsidiaries develop, produce, market, and sell pet food under the BLUE Life Protection Formula, BLUE Wilderness, BLUE Basics, BLUE Freedom, and BLUE Natural Veterinary Diet lines. Our products are produced domestically at our Heartland Facilities and through contract manufacturers for distribution to retailers in specialty channels throughout the United States of America, Canada, Japan, and Mexico.

In July 2012, Blue formed Heartland Pet Food Manufacturing, Inc. for the purpose of commencing internal manufacturing operations to eventually supplement its contract manufacturers. Manufacturing operations commenced at our Joplin Dry Food Facility in September 2014. In April 2016, Blue formed Heartland Pet Food Manufacturing Holding, LLC for the purpose of consolidating all manufacturing entities under one holding company. In April 2016, Heartland Pet Food Manufacturing Indiana, LLC was formed for our planned internal manufacturing operations in Richmond, Indiana.

Also in July 2012, BBPP and Blue Pet Products, Inc. (“BPP”) were established through a series of stock exchanges and transfers. In connection therewith, the existing stockholders of Blue became the stockholders of BBPP with the same pro-rata ownership percentage previously held in Blue and whereby BBPP owns 100% of the common stock of BPP and BPP owns 100% of the common stock of Blue.

Initial Public Offering

On July 27, 2015, BBPP completed the initial public offering (“IPO”) of shares of its common stock. Existing stockholders of BBPP sold 38,906,286 shares of common stock in the IPO at an initial offering price of $20.00 per share, including 5,074,732 shares of common stock pursuant to the full exercise of the underwriters’ option to purchase additional shares. In addition, BBPP issued 30,682 shares of common stock to approximately 1,700 non-management employees at no cost to them. The Company recognized $0.6 million of stock-based compensation expense during fiscal year 2015 related to this issuance. BBPP did not receive any proceeds from the sale of shares of its common stock in the IPO by the selling stockholders or from the issuance of shares to non-management employees. The shares offered and sold in the IPO were registered under the Securities Act of 1933 (“Securities Act”) pursuant to BBPP’s Registration Statement on Form S-1, which was declared effective by the Securities and Exchange Commission (“SEC”) on July 21, 2015. The common stock is listed on the NASDAQ Stock Market under the symbol “BUFF.”

Secondary Offerings

In July 2016 and September 2016, BBPP completed two secondary offerings of shares of its common stock. Certain existing stockholders of BBPP sold 17,250,000 and 14,300,000 shares of common stock, respectively, in the July and September secondary offerings.

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Note 2 – Basis of Presentation

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of BBPP and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Stock Split

On July 7, 2015, the Company effected a 4.2-to-1 stock split of all outstanding shares of the Company's common stock. All share, option, and per share information presented in the accompanying consolidated financial statements have been adjusted to reflect the stock split on a retroactive basis for all periods presented and all share information is rounded down to the nearest whole share after reflecting the stock split.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current period presentation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities, at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash and Cash Equivalents

Cash and cash equivalents include all cash balances and highly liquid investments purchased with original maturities of three months or less. Cash and cash equivalents consist of both interest and non-interest bearing accounts. At December 31, 2017, we had seven accounts in excess of the U.S. federal deposit insurance limit.

Receivables

Trade receivables consist of uncollateralized, non-interest bearing customer obligations due under normal trade terms. Other receivables consist primarily of reimbursable amounts due from co-manufacturers for packaging of $4.1 million and $3.8 million and income tax receivables of $5.0 million and $0.5 million at December 31, 2017 and 2016, respectively. We also maintain an allowance for doubtful accounts for estimated losses resulting from the inability of our customers to make payments and other actual and estimated deductions. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, an additional allowance could be required. Past due balances are reviewed individually for collectability. As of December 31, 2017 and December 31, 2016, the allowance for doubtful accounts was $0.8 million and $0.4 million, respectively.

Receivables consisted of the following at December 31:

| (dollars in thousands) | 2017 | 2016 |
|---|---|---|
| Trade receivables, net | $139,165 | $110,873 |
| Other receivables | 11,095 | 4,573 |
| Total | $150,260 | $115,446 |

We are exposed to concentration of credit risk by our customers. Approximately 60% of gross trade accounts receivable at December 31, 2017 and December 31, 2016 were from two customers. In 2017 and 2016, two customers accounted for 10% or more of our consolidated net sales. Sales to these customers represented 59%, and 63% and 69% for the years ended December 31, 2017, 2016 and 2015, respectively.

Inventories

Inventories, consisting principally of finished goods available for resale and packaging materials, are stated at the lower of cost or market value. We provide reserves for estimated obsolescence based on specific identification. If assumptions about future demand change or actual market conditions are less favorable than those projected by management, we may require additional reserves.

Property, Plant, and Equipment

Property, plant, and equipment are stated at cost, less accumulated depreciation and amortization. Depreciation and amortization are recognized on a straight-line basis over the estimated useful life of the assets as follows: computer equipment over 3 years, computer software over 5 years, furniture and fixtures over 10 years, machinery and equipment from 7 to 15 years, and buildings, building improvements and land improvements over 40 years. Computer software consists primarily of third-party software acquired and developed for internal use and is accounted for in accordance with accounting guidance on internal use software. Leasehold improvements and fixed assets purchased under capital leases are amortized over the lesser of the asset life or related lease term. When fixed assets are sold or otherwise disposed of, the accounts are relieved of the original cost of the assets and the related accumulated depreciation, and any resulting profit or loss is credited or charged to operations.

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Long-lived assets are considered impaired if the estimated undiscounted future cash flows of the asset or asset group are less than the carrying amount. For impaired assets, we measure and recognize a loss equal to the difference between the carrying amount of the asset or asset group and its estimated fair value.

Segment Reporting

Operating segments are components of an enterprise for which separate financial information is available that is evaluated regularly by the chief operating decision maker in deciding how to allocate resources and in assessing performance. Utilizing these criteria, we manage our business on the basis of one reportable operating segment.

Net sales in the United States (“US”) for 2017, 2016, and 2015, were $1,229 million, $1,109.3 million, and $990.5 million, respectively. Net sales outside the US for 2017, 2016, and 2015, denominated in US dollars, were $45.6 million, $40.5 million, and $36.9 million, respectively. Substantially all of our long-lived assets are located in the United States.

Revenue Recognition

Revenue consists of sales to customers, net of returns, discounts, and trade promotions. Sales are recognized when persuasive evidence of an arrangement exists, the product has been shipped, when title passes, when all risks and rewards of ownership have transferred, the sales price is fixed or determinable, and collectability is reasonably assured. In certain cases, in which we retain the risk of loss during shipment, revenue recognition does not occur until the product has reached the specified customer.

Trade promotions, consisting primarily of temporary price reductions, consumer coupons, product placement fees, advertising allowances, and other rebates are offered through various programs to customers and consumers. Sales are recorded net of trade promotion spending, which is recognized at the later of the date on which the Company recognizes the related revenue or the date on which the Company offers the incentive. Most of these arrangements have terms of approximately one year. Accruals for expected payouts under these programs are included in other current liabilities on the accompanying consolidated balance sheets.

Shipping and Handling
Shipping and handling costs include related third-party labor, warehousing, and shipping costs, shipping supplies, and certain distribution overhead. Our shipping and handling costs are included within cost of sales in the accompanying consolidated statements of income.

Vendor Concentration
We are exposed to concentration of supplier risk with our vendors. While the Company purchases products from many different manufacturers and suppliers, approximately 43%, 41%, and 44% of the Company's cost of sales in 2017, 2016, and 2015, respectively, were derived from products purchased from the Company's five largest manufacturers.

Advertising
Advertising costs, including production costs of television, print, and other advertisements, are expensed as incurred, shown or distributed. Advertising costs are included in selling, general, and administrative expenses in the accompanying consolidated statements of income and amounted to $132.3 million, $101.2 million, and $83.6 million for the years ended December 31, 2017, 2016, and 2015, respectively.

Research and Development
We engage in a variety of research and development activities principally to develop new products and improve the quality of existing products. Research and development costs are expensed as incurred. Research and development costs were $11.3 million, $9.8 million, and $9.5 million for the years ended December 31, 2017, 2016, and 2015, respectively, and are primarily reported within selling, general and administrative expenses in the accompanying consolidated statements of income.
Stock-based Compensation
In accordance with the fair value recognition provisions of accounting guidance on share-based payments, we recognize stock-based compensation expense for our share-based payments based on the fair value of the awards at the grant date. The fair value of our stock option grants is determined using the Black-Scholes option pricing model. Stock-based compensation expense is recognized on a straight-line basis over the vesting period of the stock-based award. See Note 11 for further details.

Income Taxes

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are recorded to reduce deferred tax assets when it is more likely than not that a tax benefit will not be realized.

We recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities. The tax position is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. Where applicable, interest and penalties related to unrecognized tax benefits are recognized within income tax expense, respectively.

Supplemental Cash Flow Information

Interest paid in cash approximated $14.3 million for the year ended December 31, 2017, and $15.0 million for the years ended December 31, 2016, and 2015, respectively. Income taxes paid in cash approximated $105.1 million, $54.5 million, and $54.9 million, for the years ended December 31, 2017, 2016, and 2015, respectively.

Recently Adopted Accounting Standards

In August 2016, the FASB issued ASU No. 2016-15, “Classification of Certain Cash Receipts and Cash Payments,” which amends ASC 230, Statement of Cash Flows. This ASU provides guidance on the statement of cash flows presentation of certain transactions where diversity in practice exists. The Company elected to early adopt ASU 2016-15 in the second quarter of fiscal 2017. The adoption of this standard did not have a material impact on the Company’s results of operations, cash flows or financial position.

In March 2016, the FASB Issued ASU No. 2016-09, “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting” (“ASU 2016-09”). The updated guidance changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows.

The Company elected to early adopt ASU 2016-09 in the third quarter of fiscal 2016 which requires the Company to reflect any adjustments as of January 1, 2016, the beginning of the annual period that includes the interim period of adoption. Under ASU 2016-09, all excess tax benefits and deficiencies related to employee share-based compensation will be recognized within the provision for income taxes rather than additional paid-in capital under the prior guidance. The adoption of ASU 2016-09 resulted in the recognition of excess tax benefits in our provision for income taxes of $1.4 million for the nine months ended September 30, 2016. Upon early adopting ASU 2016-09, the Company elected to change its accounting policy to record forfeitures as they occur rather than based on an estimate. This change was applied on a modified retrospective basis and the cumulative-effect adjustment was not recorded to retained earnings as of January 1, 2016 as the amount was immaterial.

Additionally, under the guidance of ASU 2016-09, the Company is required to present excess tax benefits as an operating activity in the same manner as other cash flows related to income taxes on the statement of cash flows rather than as a financing activity. The Company elected not to adjust prior year cash presentations as the impact was not material.

In August 2015, the FASB issued ASU No. 2015-15, “Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements—Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update).” The new standard is intended to address the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements which was previously not addressed in ASU No. 2015-03, “Simplifying the Presentation of Debt Issuance Costs.” The Company adopted this standard on January 1, 2016. The adoption of this standard did not have a material impact on the Company’s results of operations, cash flows or financial position.

Accounting Standards to be Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, "Revenue from Contracts with Customers (Topic 606)", which clarifies the principles for recognizing revenue. The guidance is applicable to all contracts with customers regardless of industry-specific or transaction-specific fact patterns. Further, the guidance requires improved disclosures as well as additional disclosures to help users of financial statements better understand the nature, amount, timing and uncertainty of revenue that is recognized. In 2015, the FASB issued a deferral of the effective date of the standard to the first quarter of 2018, with early adoption in fiscal 2017 permitted. In 2016, FASB issued final amendments clarifying the implementation guidance for principal versus agent considerations, identifying performance obligations and the accounting for intellectual property licenses. Upon becoming effective, the Company will apply the amendments in the updated standard either retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application.

The Company established an implementation team, completed an initial contract review, and identified differences in its current accounting policies that would result from the implementation of the new revenue standard. Based on the work performed to date, the Company expects to estimate and record certain variable payments, resulting from trade promotions and customer incentives, earlier than the historical accounting under Topic 605. The Company intends to adopt the above standards using the modified retrospective approach for the quarter ending March 31, 2018, by recognizing the cumulative effect of initially applying the new standard, driven predominantly by the acceleration of trade promotions and customer incentives, as a decrease to the opening balance of retained earnings, with an immaterial impact to our net income on an ongoing annual basis. The Company does not anticipate a material impact to net revenue to its Consolidated Statement of Income. The Company has evaluated the disclosure requirements under these standards and is implementing controls to support these new disclosure requirements, which will include additional disclosures of disaggregated net sales.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" that replaces existing lease guidance. The new standard is intended to provide enhanced transparency and comparability of organizations by requiring lease assets and lease liabilities to be recognized on the balance sheet and disclosing key information about lease arrangements. The new guidance will continue to classify leases as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income. The standard is effective for the Company beginning January 1, 2019, with early application permitted. The new standard is required to be applied with a modified retrospective approach to each prior reporting period presented with various optional practical expedients. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

In October 2016, the FASB issued ASU 2016-16, "Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory", which requires entities to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted as of the beginning of a fiscal year. The new standard must be adopted using a modified retrospective transition method which is a cumulative-effective adjustment to retained earnings as of the beginning of the first effective reporting period. The Company is currently in the process of evaluating the impact of this new standard on its consolidated financial statements.

In November 2016, the FASB issued ASU No. 2016-18, “Statement of Cash Flows (Topic 230): Restricted Cash” (“ASU 2016-18”), which provides guidance on the classification of restricted cash in the statement of cash flows. ASU 2016-18 is effective for our fiscal year beginning January1, 2019. Early adoption is permitted. The Company does not expect the adoption of ASU 2016-18 to have a material effect on its consolidated financial statements.

In May 2017, the FASB issued ASU No. 2017-09, “Compensation-Stock Compensation (Topic 718)" ("ASU 2017-09") which provides clarity and expects to reduce both (1) diversity in practice and (2) cost and complexity when applying guidance in Topic 718, to a change to the terms or conditions of a share-based award. ASU 2017-09 is effective after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted and the amendments to this ASU will be applied prospectively to an award modified on or after the adoption date. The Company does not expect to early adopt ASU 2017-09 and it is not expected to have a material effect on its consolidated financial statements.

Note 3 – Inventories

Inventories consisted of the following at December 31:

| (dollars in thousands) | 2017 | 2016 |
|---|---|---|
| Finished goods | $76,606 | $67,187 |
| Work in process | 213 | 286 |
| Raw materials | 2,104 | 2,346 |
| Packaging and supplies | 1,022 | 1,122 |
| Total | $79,945 | $70,941 |

As of December 31, 2017 and 2016, our inventory reserves were primarily for excess finished goods and packaging which totaled $5.1 million and $3.0 million, respectively.

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Note 4 – Property, Plant, and Equipment

Property, plant, and equipment consisted of the following at December 31:

| (dollars in thousands) | 2017 | 2016 |
|---|---|---|
| Buildings | $59,314 | $59,314 |
| Machinery and equipment | 52,383 | 49,079 |
| Computer software | 17,635 | 14,849 |
| Computer equipment | 4,855 | 4,599 |
| Furniture and fixtures | 1,876 | 1,772 |
| Leasehold improvements | 1,590 | 1,477 |
| Land improvements | 493 | 493 |
| Land | 395 | 401 |
| Buildings improvements | 613 | 189 |
| Construction in progress | 219,234 | 53,891 |
| | 358,388 | 186,064 |
| Accumulated depreciation and amortization | (31,984) | (23,832) |
| Total | $326,404 | $162,232 |

Depreciation and amortization expense was approximately $10.5 million, $9.2 million, and $8.2 million for the years ended December 31, 2017, 2016, and 2015, respectively.

During 2013, Heartland and Jasper County, Missouri ("Jasper") entered into an agreement pursuant to which Jasper agreed to issue up to an aggregate principal amount of $55.0 million of industrial revenue bonds ("Bonds") to be purchased by Heartland. As noted below, Jasper issued the bonds and used the proceeds from the Bonds to purchase manufacturing equipment from Heartland, which was then leased back to Heartland. As Heartland will become the owner of the equipment at the end of the lease term, the lease meets the requirements of a capital lease and the equipment is being recorded as property, plant, and equipment. The Company has the right and intends to set-off any obligation to make payments under the lease agreements with the proceeds due from the Bonds. As of December 31, 2017 and 2016 Jasper had issued, and Heartland had purchased, $55.0 million, of industrial revenue bonds and Jasper had purchased from, and leased back to, Heartland certain manufacturing equipment for a corresponding amount.
In August 2016, Heartland and the City of Joplin, Missouri, or Joplin, entered into agreements by which Joplin agreed to issue up to an aggregate principal amount of approximately $83.3 million of industrial revenue bonds to purchase from Heartland the land on which the current Joplin Dry Food Facility resides and the land on which the Jopin Treats Facility would come to reside, and the associated buildings, structures, and fixtures, including the additional manufacturing equipment included in the Joplin Treats Facility (collectively, the “Property”), which will then be leased back to Heartland. As Heartland will become the owner of the Property at the end of the lease term, the lease meets the requirements of a capital lease and the equipment and land are recorded as property, plant and equipment our balance sheet. The Company has the right and intends to set-off any obligation to make payments under the lease agreement with the amounts due under the industrial revenue bonds. As of December 31, 2017 and 2016, Joplin had issued and Heartland had purchased approximately $31.9 million and $10.8 million,

respectively, of industrial revenue bonds and Joplin had purchased from, and leased back to, Heartland certain Property for a corresponding amount.

Note 5 – Long-term Debt

Long-term debt consisted of the following at December 31:

| (dollars in thousands) | 2017 | 2016 |
|---|---|---|
| Term loan | $393,914 | $383,137 |
| Less current maturities | (4,000 ) | (3,960 ) |
| Total long-term debt | $389,914 | $379,177 |

New Credit Agreement

On May 25, 2017, the Company, as borrower, entered into a credit agreement (the "Credit Agreement") with Citibank, N.A., as administrative agent, and a syndicate of financial institutions, as lenders and other agents. The Credit Agreement provides for a $120.0 million revolving facility (the "Revolving Facility"), of which up to $10.0 million is available for letters of credit, and for a $400.0 million term loan facility (the "Term Facility"). A majority of the proceeds of the Term Facility were used to refinance the Old Credit Agreement (as defined below).

All obligations under the Credit Agreement are guaranteed by each of the material wholly-owned domestic restricted subsidiaries of the Company, subject to certain exceptions. Substantially all of the assets of the Company and each guarantor, subject to customary exceptions, are pledged as collateral in support of all obligations under the Credit Agreement, and the guarantees of those obligations.

Pursuant to the Credit Agreement, $1.0 million of the Term Facility must be repaid each fiscal quarter commencing with the fiscal quarter of the Company ending September 30, 2017. Upon maturity on May 25, 2024, the remaining principal balance of $373.0 million will be due.

Interest under the Revolving Facility and the Term Facility is payable, at the Company's option, either at a base rate (subject to a floor of 0.00% and based on the highest of the prime rate, the overnight federal funds rate plus 1/2 of 1.00% and the one-month LIBOR rate plus 1.00%) plus an applicable margin of 1.00% per annum or a LIBOR-based rate (subject to a floor of 0.00%) plus an applicable margin of 2.00% per annum. The interest payment dates of the loans are dependent on the duration of the interest periods for the types of loans selected by the Company and are set forth in the Credit Agreement. Such applicable margins will be reduced by 0.25%, in each case, if (i) the Company's Consolidated First Lien Gross Leverage Ratio (as defined in the Credit Agreement) is less than or equal to 1.00 to 1.00 or (ii) the Company maintains credit rating equal to or higher than Baa3 from Moody's and BBB- from S&P.

The Company's Term Facility and Revolving Facility contain financial covenants, including a financial covenant to maintain, commencing on December 31, 2017, a Consolidated First Lien Net Leverage Ratio ("leverage ratio"), defined as, with certain adjustments, the ratio of (i) the Company's net debt that is secured by certain liens on the collateral to (ii) consolidated net income before interest, taxes, depreciation and amortization for the most recently ended period of four consecutive fiscal quarters for which financial statements have been delivered, that does not exceed 4.00 to 1.00.

The Credit Agreement also sets forth mandatory and optional prepayment conditions, including, commencing with the fiscal year ending on December 31, 2018, an annual excess cash flow requirement, as defined, that may result in our use of cash to reduce our debt obligations.

Termination of Old Credit Agreement
On May 25, 2017, in connection with the closing of the Credit Agreement, the Company repaid in full approximately $382.0 million of borrowings under the Credit Agreement, dated as of August 8, 2012, by and among Blue Pet Products, Inc., Blue Buffalo Company, Ltd., the lenders from time to time party thereto and Citibank, N.A as administrative agent (as amended from time to time, the “Old Credit Agreement”). The credit facilities and related agreements and documents under the Old Credit Agreement were terminated and amounts due and payable thereunder were repaid upon the effectiveness of the Credit Agreement.
Accounting Treatment
Based on management’s review of the Credit Agreement and the refinancing transaction, the accounting for debt extinguishment applied. As such, the costs incurred related to third parties and debt issuance of $4.4 million were treated as a direct deduction of the net carrying amount of the Term Facility. These costs will be amortized to interest expense using the effective interest method through the Term Facility’s maturity date of May 25, 2024. There were no direct costs categorized as payments to creditors related to the Term Facility.
Fees paid to creditors of $0.3 million related to the Revolving Facility. As the borrowing capacity of the Revolving Facility is greater than the borrowing capacity that existed under the Old Credit Agreement, these costs are deferred and will be amortized to interest expense using the effective interest method over the Revolving Facility’s term, maturing on May 25, 2022.
At December 31, 2017, we had a carrying value of $393.9 million of term loan borrowings (fair value of $395.4 million) at an effective interest rate of 3.72% and no outstanding borrowings under the Revolving Facility. At December 31, 2016, the Company had $383.1 million of term loan borrowings (fair value of $386.5 million) at an effective interest rate of 3.79% and no outstanding borrowings under the revolving credit facility.
During the years ended December 31, 2017, 2016, and 2015, the Company incurred total interest expense of $14.5 million, $15.0 million and $15.1 million. During the years ended December 31, 2017 and 2016 the Company capitalized $3.4 million and $0.4 million of interest expense, respectively, related to the expansion of our internal manufacturing capabilities. No interest expense was capitalized during the year ended December 31, 2015.
The Credit Agreement contains other customary terms, including (i) representations and warranties, (ii) affirmative covenants, (iii) negative covenants, including limitations on indebtedness, liens, mergers, acquisitions, asset sales, investments, distributions, prepayments of subordinated debt, and transactions with affiliates, in each case subject to baskets, thresholds and other exceptions, and a financial covenant to maintain a certain Consolidated First Lien Net Leverage Ratio as set forth in the Credit Agreement, and (iv) customary events of default. The Company believes it was in compliance with its financial debt covenants in the Credit Agreement as of December 31, 2017.

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Note 6 – Other Current Liabilities

Other current liabilities consisted of the following at December 31:

| (dollars in thousands) | 2017 | 2016 |
|---|---|---|
| Trade promotions | $25,146 | $18,658 |
| Accrued bonuses | 11,196 | 12,951 |
| Accrued capital expenditures | 5,411 | — |
| Accrued inventory in transit | 2,921 | 5,278 |
| Accrued media | 1,287 | 10,109 |
| Other current liabilities | 25,033 | 12,633 |
| Total | $70,994 | $59,629 |

Note 7 - Income Taxes

The provision for income taxes consisted of the following:

| (dollars in thousands) | For the years ended December 31, 2017 | December 31, 2016 | December 31, 2015 |
|---|---|---|---|
| Current tax provision: | | | |
| Federal | $91,762 | $ 57,605 | $ 60,826 |
| State | 12,274 | 6,933 | 7,164 |
| Foreign | 66 | 41 | 11 |
| Total current provision | 104,102 | 64,579 | 68,001 |
| Deferred tax provision: | | | |
| Federal | (6,833) | 9,391 | (9,855) |
| State | 2,532 | 2,644 | (2,216) |
| Foreign | (5) | (47) | — |
| Total deferred (benefit) provision | (4,306) | 11,988 | (12,071) |
| Total provision | $99,796 | $ 76,567 | $ 55,930 |

Components of income (loss) before income taxes are as follows:

| | For the years ended December 31, 2017 | December 31, 2016 | December 31, 2015 |
|---|---|---|---|
| United States | $298,994 | $ 211,419 | $ 147,427 |
| Foreign | (5,669) | (4,611) | (2,109) |
| Total income before income taxes | $293,325 | $ 206,808 | $ 145,318 |

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Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

A reconciliation of the federal statutory rate to our effective rate is as follows:

| | For the years ended | | |
|---|---|---|---|
| | December 31, 2017 | December 31, 2016 | December 31, 2015 |
| Federal statutory income tax rate | 35.0 % | 35.0 % | 35.0 % |
| State income taxes, net of federal income tax benefit | 3.4 | 3.3 | 2.5 |
| Non-deductible expenses | 0.3 | 0.7 | 2.0 |
| Domestic manufacturing deduction | (1.6 ) | (1.4 ) | (1.3 ) |
| Unrecognized tax benefits | 1.3 | 0.5 | 0.8 |
| Valuation allowance | — | 0.5 | 0.5 |
| Stock option exercises | (2.6 ) | (0.7 ) | — |
| Impact of Tax Act | (1.8 ) | — | — |
| Other | — | (0.9 ) | (1.0 ) |
| Total | 34.0 % | 37.0 % | 38.5 % |

The Company and its subsidiaries file income tax returns in the United States and various state and local, and foreign jurisdictions.

In the normal course of business, the Company is subject to examination by taxing authorities and as of December 31, 2017, the Company's 2012 through 2013 income tax returns were being audited by the Internal Revenue Service ("IRS”). There are also various state tax examinations in progress primarily attributable to state nexus matters relating to prior year amended tax returns which have been considered in the Company’s position for uncertain tax benefits. In general, tax years 2011 through 2017 are subject to an examination for U.S. Federal and tax years 2011 through 2017 for some state and local taxing jurisdictions.

As of December 31, 2017, 2016, and 2015 the liability for income taxes associated with uncertain tax positions was $12.4 million, $9.7 million, and $8.7 million, respectively, which if recognized, would affect our effective tax rate.

The following is a reconciliation of the beginning and ending amount of unrecognized tax benefits (which excludes federal benefits of state taxes, interest, and penalties):

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

| (dollars in thousands) | |
|---|---|
| Balance at December 31, 2014 | $7,518 |
| Increases in uncertain tax benefits as a result of tax positions taken in the current year | 1,845 |
| Decreases in uncertain tax benefits from a lapse of applicable statute of limitations | (156) |
| Balance at December 31, 2015 | $9,207 |
| Increases in uncertain tax benefits as a result of tax positions taken in a prior year | 287 |
| Increases in uncertain tax benefits as a result of tax positions taken in the current year | 1,367 |
| Decreases in uncertain tax benefits from a lapse of applicable statute of limitations | (233) |
| Decreases in uncertain tax benefits as a result of tax positions taken in a prior year | (2,028) |
| Balance at December 31, 2016 | $8,600 |
| Increases in uncertain tax benefits as a result of tax positions taken in a prior year | 1,013 |
| Increases in uncertain tax benefits as a result of tax positions taken in the current year | 545 |
| Decreases in uncertain tax benefits from a lapse of applicable statute of limitations | (739) |
| Decreases in uncertain tax benefits as a result of tax positions taken in a prior year | (93) |
| Balance at December 31, 2017 | $9,326 |

The Company recognizes interest and penalties related to unrecognized tax benefits as a component of income tax expense. For the years ended December 31, 2017 and 2016, the Company recorded approximately $0.2 million and $0.8 million, respectively, of interest and $1.1 million and $0.4 million, respectively, of penalties related to its unrecognized tax benefits.

Based upon the expiration of statutes of limitations and possible settlements in several jurisdictions, we believe it is reasonably possible that the total amount of previously unrecognized tax benefits may decrease by approximately $0.1 million within twelve months after the year ended December 31, 2017.

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Components of deferred tax assets and liabilities were as follows:

| (dollars in thousands) | December 31, 2017 | December 31, 2016 |
|---|---|---|
| Deferred tax assets: | | |
| Inventories | $2,010 | $ 1,440 |
| Accrued liabilities | 249 | 413 |
| Stock-based compensation | 1,587 | 2,544 |
| Long-term incentive plan | 849 | 1,600 |
| State net operating loss carryforwards | 317 | 1,509 |
| Foreign net operating loss carryforwards | 2,740 | 1,380 |
| State tax credits | 1,514 | 1,447 |
| Federal benefit related to uncertain tax positions | 1,922 | 2,724 |
| Other | 664 | 1,057 |
| Deferred tax assets, gross | 11,852 | 14,114 |
| Valuation allowance | (3,489) | (1,772) |
| Total deferred tax assets, net | 8,363 | 12,342 |
| | | |
| Deferred tax liabilities: | | |
| Property, plant, and equipment | (14,910) | (22,173) |
| Other | (496) | (1,518) |
| Total deferred tax liabilities | (15,406) | (23,691) |
| | | |
| Net deferred tax liabilities | $(7,043) | $ (11,349) |

As of December 31, 2017, the Company has Missouri state NOLs of $0.2 million and Connecticut NOLs of $4.7 million; these NOLs begin to expire in 2034, 2027, respectively. The Company also has Connecticut research and development tax credit carryforwards of approximately $0.3 million as of December 31, 2017; these credits will begin to expire in 2026. As of December 31, 2017 the Company has Japan NOLs of $7.8 million, Mexico NOLs of $2.8 million and Canada NOLs of $0.1 million; these NOLs will begin to expire in 2024, 2024 and 2034, respectively.

As of December 31, 2017, the Company had a valuation allowance of $3.5 million to reduce our deferred tax assets to an amount more likely than not to be realized. This valuation allowance relates to state tax credits and foreign net operating losses. In evaluating the Company’s ability to realize its deferred tax assets, management considers whether it is more likely than not that some or all of the deferred tax assets will not be realized. Management also considers the projected reversal of deferred tax liabilities and projected future taxable income in making this assessment. Based upon this assessment, management believes it is more likely than not that the Company will realize the benefits of these deductible differences, net of valuation allowance. There was a $1.8 million valuation allowance recorded as of December 31, 2016.

The Company has not provided deferred taxes on undistributed earnings from its foreign subsidiaries, as the Company anticipates that these earnings will be reinvested indefinitely. The Company does not currently plan to initiate any action that would result in these earnings being repatriated to fund its U.S. operations.

On December 22, 2017 President Donald Trump signed into law The Tax Cuts and Job Act of 2017 (“Tax Act”). The legislation created many changes in the current tax law. However; the key areas that are expected to impact the Company include: the reduction in the Federal tax rate to 21% effective January 1, 2018, the removal of the Domestic Activities Production Deduction (“DPAD”) effective January 1, 2018, the deemed repatriation of foreign unremitted earnings, and the allowance for 100% bonus depreciation for fixed assets placed in service after September 27, 2017. The Company has revalued its deferred tax liability as of December 31, 2017, and determined that the liability will be reduced by about $5.4 million. This adjustment has been included in tax expense for the period ending December 31, 2017, and impacted the rate by about (1.8%). The Company has also looked at its cumulative foreign earnings in its various subsidiaries and determined that at this time the impact of the deemed repatriation of foreign unremitted earnings is immaterial. Going forward the Company anticipates that the increase in bonus depreciation, removal of DPAD and decrease in the Federal tax rate will impact the company’s tax expense and effective tax rate. The Company expects additional guidance to be issued with respect to the Tax Act in future periods, however, such guidance is not expected to have a material impact on the provisional amount recorded for the year ended December 31, 2017. The Company will continue to monitor such clarifying guidance as issued and reassess the potential impact as necessary in future periods.

Note 8 – Fair Value Measurements

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, other current liabilities, deferred compensation, and debt, none of which are measured at fair value on a recurring basis. The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable, and other current liabilities approximate their fair value due to the short-term nature of these financial instruments. The Company’s long-term financial liability consists of long-term debt. Long-term debt is recorded on the consolidated balance sheets at issuance price and adjusted for any applicable unamortized discounts or premiums.

The Company accounts for its fair value measurements in accordance with accounting guidance which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The fair value hierarchy for disclosure of fair value measurements is as follows:

Level 1- Quoted prices in active markets for identical assets or liabilities
Level 2- Quoted prices for similar assets and liabilities in active markets or inputs that are observable
Level 3- Inputs that are unobservable (for example, cash flow modeling inputs based on assumptions)

At December 31, 2017 and December 31, 2016, we had approximately $255.1 million and $270.9 million, respectively, of cash invested in interest bearing demand deposit accounts and money market deposit accounts which were included in cash and cash equivalents on the accompanying consolidated balance sheets (Level 1).

The Company reports transfers in and out of Levels 1, 2, and 3, as applicable, using the fair value of the individual securities as of the beginning of the reporting period in which the transfer(s) occurred. There were no transfers in or out of Level 1, 2, or 3 during the years ended December 31, 2017 and 2016.

Assets that are measured at fair value on a nonrecurring basis relate primarily to our tangible fixed assets. For these assets, we do not periodically adjust carrying value to fair value, except in the event of impairment. Should we determine that an impairment has occurred, the carrying value would be reduced to fair value and the difference is recorded as an impairment loss in our consolidated statements of income.

As of December 31, 2017, the carrying value of the Company’s outstanding borrowings under the credit facility was approximately $393.9 million as compared to a fair value of $395.4 million (Level 2). As of December 31, 2016, the carrying value of the Company’s outstanding borrowings under the credit facility was approximately $383.1 million as compared to a fair value of $386.5 million (Level 2). The estimated fair value of the Company’s debt was based primarily on reported market values, recently completed market transactions and estimates based upon interest rates, maturities, and credit risk.

Note 9 – Employee Benefit Plans

The Company sponsors a defined contribution plan. This plan covers employees who are at least 18 years of age and have completed a 6-month time period of employment. Employees are eligible to participate in the plan on the first day of the plan year month coinciding with the date in which the employee satisfies the eligibility requirements. The plan provides for the option of employee contributions up to statutory limits, of which we match up to 4% of the employees contributions, at a rate of 100% on the first 3% and 50% on the next 2%. Company contributions to the plan totaled approximately $1.0 million for each of the years ended December 31, 2017, 2016, and 2015.

Note 10 - Stockholders' Equity

During the year ended December 31, 2015, the Company filed an Amended and Restated Articles of Incorporation which, among other things, increased the number of authorized shares to 1,500,000,000 shares of common stock, par value  $0.01 per share, and authorized 150,000,000 shares of blank check preferred stock, par value of $0.01 per share, which may be issued in one or more series of Preferred Stock with such powers, preferences and relative, participating, optional and other special rights, and the qualifications, limitations or restrictions as the Board of Directors of the Company shall approve.

As of December 31, 2017, the total amount of the Company's authorized common and preferred stock consisted of 1,500,000,000 and 150,000,000 shares, respectively. As of December 31, 2017, shares of common stock that were issued and outstanding were 197,615,064 and 195,522,290, respectively. There were no shares of preferred stock issued or outstanding as of December 31, 2017.

Treasury Stock

On July 31, 2017, the Board of Directors approved the terms of a share repurchase program, under which the Company was authorized to repurchase up to $50 million of its common shares. This authority was primarily used to offset dilution caused by the issuance and exercise of stock options and other equity compensation programs. The Company repurchased shares through open market purchases in accordance with applicable federal securities laws, including through Rule 10b5-1 trading plans and under Rule 10b-18 of the Securities Exchange Act of 1934. Purchases were made at times and prices considered appropriate by management. Repurchased common stock is available for use in connection with the Company's stock plans and for other corporate purposes. Based on the Company’s strong cash flow and balance sheet, this program did not impact our ability to execute our business plans, allocate capital for our capital investment projects or pursue other strategic initiatives. The Company financed the share repurchase program through its operating cash flow and cash on hand.

During August 2017, the Company repurchased approximately 2.1 million shares of its common stock through open market purchases at an average price of $23.89, and a total cost of $50.0 million, including broker's commissions. As of December 31, 2017, the share repurchase program was fully executed.

The repurchase of these shares by the Company was accounted for under the cost method. The share repurchases were recorded as "Treasury stock, at cost" on the Consolidated Balance Sheets.

Note 11 – Stock-Based Compensation

Under the Company’s 2012 Blue Buffalo Pet Products, Inc. Stock Purchase and Option Plan (the “Plan”), the Board of Directors is authorized to award incentive stock options (ISOs) and non-qualified, stock appreciation rights (SARs), restricted stock, performance units, performance-based stock awards, dividend equivalent rights, and other stock-based grants. Participation in the Plan is limited to key employees, officers, and directors.

On March 4, 2013, the Plan was amended to increase the maximum number of shares of stock available under the Plan by 210,000 shares to 14,242,061 shares (the “Amended Plan”). As of December 31, 2017, there were 5,230,642 shares of common stock reserved under the Amended Plan. As of December 31, 2017, the maximum number of shares available for grant under the Amended Plan was 205,978.

In July 2015, the Board of Directors adopted and our shareholders approved the Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (“2015 Plan”). The 2015 Plan provides that the total number of shares of common stock that may be issued under our 2015 Plan is 8,400,000. The 2015 Plan provides for the grant of stock options (ISOs and non-qualified), SARs, restricted stock awards (RSAs), restricted stock units (RSUs), performance units, performance-based stock awards, dividend equivalent rights and other stock-based incentive awards. As of December 31, 2017, the Company has granted 114,051 RSAs, 157,792 RSUs, and 574,187 stock options under the 2015 Plan. As of December 31, 2017, the maximum number of shares available for grant under the 2015 Plan was 7,552,780.

Stock Options

The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options on the date of grant. Stock options granted under the 2012 plan are subject to pro-rata vesting and grants under the 2015 Plan are subject to cliff vesting. The fair value of stock options is expensed on a straight-line basis over the vesting period.

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Prior to the IPO, the Company used a third party valuation specialist to assist it in the estimation of the fair value of its common stock. The Company believed these valuations to be appropriate; however, the valuation of the equity of any private company involves various estimates and assumptions that may differ from actual values. Effective with the IPO, the Company bases its common stock value on quoted market prices. The expected volatility assumption is based on the combination of the Company's historical volatility and selected companies from its peer group. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury implied yield at the date of grant. The weighted-average expected term is determined with reference to historical exercise and post-vesting cancellation experience, and the vesting period and contractual term of the awards.

The following are the weighted-average assumptions used for grants issued:

| | For the years ended December 31, 2017 | December 31, 2016 | December 31, 2015 |
|---|---|---|---|
| Volatility | 30.68 % | 32.58 % | 23.85 % |
| Risk-free interest rate | 1.93 % | 1.23 % | 1.88 % |
| Expected term (years) | 5 | 5 | 6.5 |
| Dividend yield | — | — | — |
| Grant-date fair value | $ 7.00 | $ 7.81 | $ 5.74 |

The following table summarizes stock option activity during the year and also presents stock options outstanding and exercisable as of December 31, 2017 (dollars in millions, except for per share data):

| | Number of Shares | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Life (In Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding, December 31, 2016 | 4,248,156 | $ 7.21 | | |
| Granted | 383,887 | $ 23.00 | | |
| Exercised | (1,055,624) | $ 5.71 | | |
| Forfeited | (117,245) | $ 15.99 | | |
| Expired | (42,641) | $ 10.73 | | |
| Outstanding, December 31, 2017 | 3,416,533 | $ 9.09 | 3.58 | $ 81.1 |
| Exercisable, December 31, 2017 | 2,727,179 | $ 5.83 | 2.35 | $ 73.6 |

During 2017, the Company granted 184,752 ISOs and 199,135 nonqualified stock options. The intrinsic value of options exercised during 2017, 2016, and 2015, was $22.1 million, $4.6 million, and $5.5 million, respectively. In accordance with the early adoption of ASU 2016-09, the Company recorded $1.5 million of excess tax benefits from the exercise of stock options to our provision for income taxes during 2016. Under the previous guidance, the Company recorded $1.5 million of excess tax benefits from the exercise of stock options to additional paid-in capital during the year ended December 31, 2015.

Restricted Stock

The following table summarizes RSA and RSU activity for the year ended December 31, 2017:

| | RSAs | | RSUs | |
|---|---|---|---|---|
| | Number of Shares | Weighted Average Grant Date Fair Value | Number of Shares | Weighted Average Grant Date Fair Value |
| Outstanding at December 31, 2016 | — | $ — | 61,861 | $ 25.45 |
| Granted | 35,430 | $ 23.00 | 106,609 | $ 23.00 |
| Vested | (35,430) | $ 23.00 | (1,220 ) | $ 24.58 |
| Forfeited | — | $ — | (9,458 ) | $ 24.44 |
| Outstanding at December 31, 2017 | — | $ — | 157,792 | $ 23.86 |

During the year ended December 31, 2017, members of the Company's Board of Directors received a fully-vested grant of 35,430 RSAs with a three-year holding restriction under the 2015 Plan. The total fair value of these RSAs on the date of grant was $0.8 million, of which the full amount was recognized as a component of stock-based compensation expense during the year ended December 31, 2017.

During the year ended December 31, 2017, the Company granted 106,609 RSUs under the 2015 Plan to its employees. The stock-based compensation cost for RSUs is measured based on the closing fair market value of the Company's common stock on the date of grant. RSUs have a three-year cliff vesting term. The total fair value of these restricted stock units on the date of grant was $2.5 million, which will be recognized as a component of stock-based compensation expense and amortized on a straight-line basis over the three-year vesting term.

Stock-based Compensation Expense

Unrecognized stock-based compensation related to outstanding unvested stock options and restricted stock units is expected to be recognized in the Company’s statements of income as follows (by fiscal year):

| (dollars in thousands) | |
|---|---|
| 2018 | $2,819 |
| 2019 | 1,974 |
| 2020 | 457 |
| Total | $5,250 |

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

## Note 12 - Earnings Per Share

The details of the computation of basic and diluted earnings per common share are as follows:

| | Twelve months ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| (dollars in thousands, except for share data) | | | |
| Net income | $193,529 | $ 130,241 | $ 89,388 |
| | | | |
| Basic weighted average number of shares outstanding | 196,256,128 | 196,363,084 | 195,933,800 |
| Dilutive effect of stock options and RSUs | 2,662,289 | 2,985,662 | 2,113,653 |
| Diluted weighted average number of shares outstanding | 198,918,417 | 199,348,746 | 198,047,453 |
| | | | |
| Basic net income per common share | $0.99 | $ 0.66 | $ 0.46 |
| Diluted net income per common share | $0.97 | $ 0.65 | $ 0.45 |
| Anti-dilutive shares excluded from diluted earnings per share computation | 512,684 | 275,194 | 49,795 |

## Note 13 - Lease Commitments

The Company leases various facilities, vehicles, and equipment under operating leases with terms expiring at various times through 2025. Rent expense under operating leases was approximately $5.8 million, $5.3 million, and $5.6 million for the years ended December 31, 2017, 2016, and 2015, respectively.

Future minimum annual rental commitments under non-cancellable operating leases as of December 31, 2017 were as follows:

| (dollars in thousands) Year | Total non-cancellable leases |
|---|---|
| 2018 | $ 6,843 |
| 2019 | 6,676 |
| 2020 | 6,029 |
| 2021 | 5,123 |
| Thereafter | 11,186 |
| Total | $ 35,857 |

Blue Buffalo Pet Products, Inc.
Notes to Consolidated Financial Statements (Continued)

Note 14 - Commitments and Contingencies

Purchase Commitments
The Company enters into contracts with a network of contract manufacturers that require them to provide us with specific finished products and provide for minimum production commitments. Most of our agreements with our contract manufacturers expire in 2018 and will thereafter be automatically renewed for consecutive one-year terms until notice of non-renewal is given. The Company also enters into contracts for the purchase of several of its main ingredients. Such contracts call for minimum purchase requirements and typically cover one year or one crop season and are renewed annually.

The following table summarizes our future minimum purchase commitments as of December 31, 2017:

| | Total | Less Than 1 Year | 1-3 Years | 3-5 Years | More Than 5 Years |
|---|---|---|---|---|---|
| (dollars in thousands) | | | | | |
| Finished goods minimum purchase obligations | $15,863 | $13,596 | $2,267 | $ — | $ — |
| Raw material purchase obligations | 456,909 | 333,789 | 123,120 | — | — |
| Total contractual obligations | $472,772 | $347,385 | $125,387 | $ — | $ — |

Litigation & Settlements

We are a party to a number of pending claims and lawsuits arising in the normal course of business, including proceedings involving tort and other general liability claims, workers' compensation and other employee claims, and claims relating to our advertising and intellectual property.

We maintain general and other liability insurance; however, certain costs of defending lawsuits are not covered by or are only partially covered by insurance policies, and our insurance carriers could refuse to cover certain claims in whole or in part. We regularly evaluate our ultimate liability with respect to such claims and lawsuits. We accrue potential losses from litigation as they become probable and estimable.

We do not consider our ultimate liability with respect to any single claim or lawsuit, or the aggregate of such claims and lawsuits, to be material in relation to our consolidated financial condition, results of operations, or our cash flows taken as a whole.
Nestlé Purina and Related Litigations
On November 2, 2016, we entered into a settlement agreement with Nestlé Purina Petcare Company ("Nestlé Purina") pursuant to which we paid Nestlé Purina $32.0 million, each party dismissed all of its claims and counterclaims against the other, including claims raised in the parties' longstanding litigation in the United States District Court for the Eastern District of Missouri, with prejudice, and we dismissed, with prejudice, our claims against Nestlé Purina's advertising and public relations agencies (the "Nestlé Purina Settlement").

On December 9, 2015, we entered into a settlement agreement to resolve thirteen consolidated class action lawsuits in the U.S. (the “Class Action Settlement”). Under the terms of the Class Action Settlement, we agreed to pay \$32.0 million into a settlement fund, and on January 8, 2016, we paid this \$32.0 million into an escrow account pending final court approval. Attorneys’ fees awarded by the court and all costs of notice and claims administration were paid from the settlement fund.

## Note 15 - Related Parties

Invus Partners, LLC, which as of December 31, 2017, beneficially owned 44.7% of the Company's outstanding common stock, and held \$19.6 million and \$19.8 million of the Company's outstanding debt under the Term Facility and Amended Facility on December 31, 2017 and 2016, respectively. Several of the members of the Company's Board of Directors ("BOD") are members of Invus Partners, LLC, as well as managing directors and officers of the general partner of the Company's majority shareholder and managing directors and officers of an investment advisor to the Company's majority shareholder.

In addition, Kunkemueller Enterprises LP, which is owned in part by the wife of one of the members of our BOD, held \$1.5 million and \$1.4 million of the Company's debt under the Term Facility and Amended Facility on December 31, 2017 and 2016, respectively.

Note 16 - Unaudited Quarterly Financial Data

The unaudited summarized financial data by quarter for the years ended December 31, 2017 and 2016 is presented in the table below:

| | Quarter 1 | Quarter 2 | Quarter 3 | Quarter 4 |
|---|---|---|---|---|
| 2017: | | | | |
| Net sales | $ 301,951 | $ 294,831 | $ 340,845 | $ 336,963 |
| Gross profit | 138,675 | 137,737 | 160,817 | 151,859 |
| Selling, general, and administrative expenses | 66,311 | 69,423 | 75,188 | 75,049 |
| Operating income | 72,364 | 68,314 | 85,629 | 76,810 |
| Net income | 44,090 | 42,682 | 53,137 | 53,620 |
| Basic net income per common share | $ 0.22 | $ 0.22 | $ 0.27 | $ 0.27 |
| Diluted net income per common share | $ 0.22 | $ 0.21 | $ 0.27 | $ 0.27 |
| Basic weighted average shares | 196,621,906 | 196,994,210 | 196,121,691 | 195,302,613 |
| Diluted weighted average shares | 199,524,913 | 199,618,809 | 198,659,459 | 197,889,189 |
| 2016: | | | | |
| Net sales | $ 279,836 | $ 286,850 | $ 287,996 | $ 295,096 |
| Gross profit | 123,232 | 127,303 | 133,209 | 131,939 |
| Selling, general, and administrative expenses | 59,756 | 65,600 | 65,493 | 71,912 |
| Operating income | 63,476 | 61,703 | 35,716 | 60,027 |
| Net income | 37,333 | 36,624 | 21,482 | 34,802 |
| Basic net income per common share | $ 0.19 | $ 0.19 | $ 0.11 | $ 0.18 |
| Diluted net income per common share | $ 0.19 | $ 0.18 | $ 0.11 | $ 0.17 |
| Basic weighted average shares | 196,217,311 | 196,270,119 | 196,445,684 | 196,516,632 |
| Diluted weighted average shares | 198,160,465 | 198,441,315 | 199,452,308 | 199,446,875 |

Note 17 - Subsequent Events

Proposed Merger with General Mills, Inc.

On February 22, 2018, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) by and among General Mills, Inc. (“GMI”), the Company and Bravo Merger Corp. (“Merger Sub”). Pursuant to the Merger Agreement, on the terms and subject to the conditions set forth in the Merger Agreement, Merger Sub will be merged with and into the Registrant (the “Merger”), with the Registrant continuing as the surviving company in the Merger and a wholly-owned subsidiary of GMI. Subject to the terms and conditions set forth in the Merger Agreement, at the effective time of the Merger, each share of common stock, par value $0.01 per share, of the Company issued and outstanding immediately prior to the effective time of the Merger (other than shares of the Company’s common stock held by GMI, Merger Sub or any other wholly-owned subsidiary of GMI, shares owned by the Company (including shares held in treasury) or any of its wholly-owned subsidiaries, and shares owned by stockholders who have properly exercised and perfected appraisal rights under Delaware law) will be converted into the right to receive $40.00 per share in cash, without interest.

Completion of the Merger is subject to certain conditions, including the satisfaction of certain regulatory approvals and other customary closing conditions. Holders of more than 50% of the Company’s outstanding shares have approved the transaction and no other approval of the Company’s Board of Directors or shareholders is required to complete the transaction. The parties expect to close the transaction in the second quarter of 2018.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures
We maintain a set of disclosure controls and procedures as that term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act that are designed to ensure that information required to be disclosed by the Company in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms. The design of any disclosure controls and procedures is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Any controls and procedures, no matter how well designed and operated, can provide only reasonable, not absolute, assurance of achieving the desired control objectives. In accordance with Rule 13a-15(b) of the Exchange Act, as of the end of the period covered by this Annual Report on Form 10-K, an evaluation was carried out under the supervision and with the participation of our management, including our Chief Executive Officer and Executive Vice President and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures. Based on that evaluation, our Chief Executive Officer and Executive Vice President and Chief Financial Officer concluded that our disclosure controls and procedures, as of the

end of the period covered by this annual report, were effective to provide reasonable assurance that information required to be disclosed by the Company in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to our management, including our Chief Executive Officer and Executive Vice President and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Management’s Report on Internal Control over Financial Reporting

Management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act). The Company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States. Internal control over financial reporting includes those policies and procedures that:

(i) pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of our assets;

(ii) provide reasonable assurance that the transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of management and our board of directors; and

(iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance of achieving their control objectives. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management, with the participation of our Chief Executive Officer and Executive Vice President and Chief Financial Officer, evaluated the effectiveness of our internal control over financial reporting as of December 31, 2017. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework (2013). Based on this evaluation, management concluded that, as of December 31, 2017, our internal control over financial reporting was effective.

Our internal control over financial reporting as of December 31, 2017, has been audited by KPMG LLP, the independent registered public accounting firm that audited the Company’s Consolidated Financial Statements included in this Annual Report on Form 10-K, as stated in their attestation report, which is included herein.

Changes in Internal Control over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during our fourth quarter of fiscal 2017 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B. OTHER INFORMATION

None.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE
The information required by this item is incorporated herein by reference to the definitive proxy statement relating to our 2018 Annual Meeting of Stockholders. We intend to file such definitive proxy statement with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.
ITEM 11. EXECUTIVE COMPENSATION
The information required by this item is incorporated herein by reference to the definitive proxy statement relating to our 2018 Annual Meeting of Stockholders. We intend to file such definitive proxy statement with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.
ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

EQUITY COMPENSATION PLAN INFORMATION
The following table sets forth information with respect to shares of our common stock that may be issued under our existing equity compensation plans, as of December 31, 2017:

| Plan Category | (a) Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights | | (b) Weighted Average Exercise Price of Outstanding Options, Warrants and Rights | (c) Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---|---|---|---|---|
| Equity compensation plans approved by security holders: | | | | |
| Amended and Restated 2012 Stock Purchase and Option Plan of Blue Buffalo Pet Products, Inc. | 2,842,346 | (1) | $ 6.12 | 205,978 |
| Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan | 731,979 | (2) | $ 23.83 | 7,552,780 |
| Equity compensation plans not approved by security holders | — | | N/A | — |
| Total | 3,574,325 | | | 7,758,758 |

(1) Consists of 2,842,346 stock options.
(2) Consists of 157,792 restricted stock units and 574,187 stock options.

The remaining information required by this item is incorporated herein by reference to the definitive proxy statement relating to our 2018 Annual Meeting of Stockholders. We intend to file such definitive proxy statement with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the definitive proxy statement relating to our 2018 Annual Meeting of Stockholders. We intend to file such definitive proxy statement with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

## ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information required by this item is incorporated herein by reference to the definitive proxy statement relating to our 2018 Annual Meeting of Stockholders. We intend to file such definitive proxy statement with the SEC pursuant to Regulation 14A within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES



(B) Exhibits:

| Exhibit Number | Description of Exhibits |
|---|---|
| 3.1 | Amended and Restated Certificate of Incorporation of Blue Buffalo Pet Products, Inc. (incorporated by reference to Exhibit 3.1 to the Company’s Current Report on Form 8-K filed on July 27, 2015). |
| 3.2 | Amended and Restated Bylaws of Blue Buffalo Pet Products, Inc. (incorporated by reference to Exhibit 3.2 to the Company’s Current Report on Form 8-K filed on July 27, 2015). |
| 10.1** | Amended and Restated Investor Rights Agreement, dated January 21, 2015, by and among the Registrant, certain stockholders party thereto and Invus, L.P. (incorporated by reference to Exhibit 10.1 to the Blue Buffalo Pet Products, Inc. Registration Statement on Form S-1 (file no. 333-204847) filed on June 10, 2015 (the "June 10, 2015 Form S-1")). |
| 10.2†** | Form of Director and Officer Indemnification Agreement (incorporated by reference to Exhibit 10.2 to the June 10, 2015 Form S-1). |
| 10.3†** | Offer Letter, dated September 12, 2012, between Michael Nathenson and Blue Buffalo (incorporated by reference to Exhibit 10.3 to the Blue Buffalo Pet Products, Inc. Registration Statement on Form S-1/A (file no. 333-204847) filed on July 8, 2015 (the "July 8, 2015 Form S-1/A")). |
| 10.4†** | Offer Letter, dated October 1, 2012, between Kurt T. Schmidt and Blue Buffalo (incorporated by reference to Exhibit 10.4 to the July 8, 2015 Form S-1/A). |
| 10.4A†** | Retirement and Separation Agreement, dated November 9, 2016, between Blue Buffalo Pet Products, Inc. and Kurt Schmidt (incorporated by reference to Company’s Current Report on Form 8-K filed November 10, 2016). |
| 10.5†** | Amended and Restated 2012 Stock Purchase and Option Plan of Blue Buffalo Pet Products, Inc. (incorporated by reference to Exhibit 10.5 to the June 10, 2015 Form S-1). |

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| 10.6†** | Form of 2012 Stock Purchase and Option Plan of Blue Buffalo Pet Products, Inc. Incentive Stock Option Agreement (incorporated by reference to Exhibit 10.6 to the June 10, 2015 Form S-1). |
| 10.7†** | Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.7 to the July 8, 2015 Form S-1/A). |
| 10.8†** | Form of Option Agreement under the Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.8 to Annual Report on Form 10-K filed with the SEC on March 10, 2016). |
| 10.9†** | Form of Restricted Stock Unit Agreement under the Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-K filed with the SEC on March 10, 2016). |
| 10.10†** | Form of Restricted Stock Agreement under the Blue Buffalo Pet Products, Inc. 2015 Omnibus Incentive Plan (incorporated by reference to Exhibit 10.10 to the July 8, 2015 Form S-1/A). |
| 10.11†** | Form of Confidentiality, Intellectual Property Ownership and Non-Competition Agreement (incorporated by reference to Exhibit 10.11 to the Blue Buffalo Pet Products, Inc. Registration Statement on Form S-1/A (file no. 333-204847) filed on June 25, 2015 (the "June 25, 2015 Form S-1/A")). |
| 10.12** | Credit Agreement dated May 25, 2017 among Blue Pet Products, Inc., the Lenders from time to time parties thereto, Citigroup Global Markets Inc. and JPMorgan Chase Bank, N.A., as Joint Lead Arrangers and Joint Bookrunners, Citibank, N.A., as Administrative Agent and JPMorgan Chase Bank, N.A., as Syndication Agent (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on May 31, 2017). |
| 21.1 | Subsidiaries of Blue Buffalo Pet Products, Inc. |
| 23.1 | Consent of Independent Registered Public Accounting Firm. |
| 31.1 | Certification of Periodic Report by Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Periodic Report by Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and 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 (filed herewith). |
| 101.SCH | XBRL Taxonomy Extension Schema Document (filed herewith). |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document (filed herewith). |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document (filed herewith). |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document (filed herewith). |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document (filed herewith). |

** Previously filed.

†Identifies exhibits that consist of a management contract or compensatory plan or arrangement.
The agreements and other documents filed as exhibits to this report are not intended to provide factual information or other disclosure other than with respect to the terms of the agreements or other documents themselves, and you should not rely on them for that purpose. In particular, any representations and warranties made by us in these agreements or other documents were made solely within the specific context of the relevant agreement or document and may not describe the actual state of affairs as of the date they were made or at any other time.

ITEM 16. FORM 10-K SUMMARY

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

BLUE BUFFALO PET PRODUCTS, INC.

By: /s/ William Bishop, Jr.
William Bishop, Jr.
Chief Executive Officer and President

Date: February 26, 2018

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

| | | |
|---|---|---|
| /s/ William Bishop, Jr.<br>William Bishop, Jr. | Chief Executive Officer, President, and Director<br>(Principal Executive Officer) | February 26, 2018<br>Date |
| /s/ Michael Nathenson<br>Michael Nathenson | Executive Vice President, Chief Financial Officer, and Treasurer<br>(Principal Financial Officer and Principal Accounting Officer) | February 26, 2018<br>Date |
| /s/ William Bishop<br>William Bishop | Non-Executive Chairman of the Board and Director | February 26, 2018<br>Date |
| /s/ Raymond Debbane<br>Raymond Debbane | Director | February 26, 2018<br>Date |
| /s/ Philippe Amouyal<br>Philippe Amouyal | Director | February 26, 2018<br>Date |
| /s/ Evren Bilimer<br>Evren Bilimer | Director | February 26, 2018<br>Date |
| /s/ Aflalo Guimaraes<br>Aflalo Guimaraes | Director | February 26, 2018<br>Date |
| /s/ Michael A. Eck<br>Michael A. Eck | Director | February 26, 2018<br>Date |
| /s/ Frances Frei<br>Frances Frei | Director | February 26, 2018<br>Date |
| /s/ Amy Schulman<br>Amy Schulman | Director | February 26, 2018<br>Date |