

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

Sprouts Farmers Market, Inc.
Form 10-Q
November 03, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended October 2, 2016

Commission File Number: 001-36029

Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

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

incorporation or organization) Identification No.)

5455 East High Street, Suite 111

Phoenix, Arizona 85054

(Address of principal executive offices and zip code)

(480) 814-8016

(Registrant's telephone number, including area code)

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

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

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

As of November 2, 2016, there were outstanding 142,329,212 shares of the registrant’s common stock, \$0.001 par value per share.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED OCTOBER 2, 2016

TABLE OF CONTENTS

	Page
<u>PART I - FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements.</u>	1
<u>Consolidated Balance Sheets as of October 2, 2016 and January 3, 2016 (unaudited)</u>	1
<u>Consolidated Statements of Operations for the thirteen and thirty-nine weeks ended October 2, 2016 and September 27, 2015 (unaudited)</u>	2
<u>Consolidated Statements of Stockholders' Equity for the thirty-nine weeks ended October 2, 2016 and the year ended January 3, 2016 (unaudited)</u>	3
<u>Consolidated Statements of Cash Flows for the thirty-nine weeks ended October 2, 2016 and September 27, 2015 (unaudited)</u>	4
<u>Notes to Unaudited Consolidated Financial Statements</u>	5
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.</u>	17
<u>Item 3. Quantitative and Qualitative Disclosures About Market Risk.</u>	28
<u>Item 4. Controls and Procedures.</u>	29
<u>PART II - OTHER INFORMATION</u>	
<u>Item 1. Legal Proceedings.</u>	30
<u>Item 1A. Risk Factors.</u>	30
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.</u>	30
<u>Item 6. Exhibits.</u>	31
<u>Signatures</u>	32

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains “forward-looking statements” that involve substantial risks and uncertainties. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (referred to as the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (referred to as the “Exchange Act”), including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, and plans and objectives of management. In some cases, you can identify forward-looking statements by terms such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “might,” “plan,” “project,” “will,” “would,” “should,” “could,” “can,” “predict,” “potential,” “objective,” or the negative of these terms, and similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievement to be materially different from those expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors” included in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K for the fiscal year ended January 3, 2016, and our other filings with the Securities and Exchange Commission. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

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

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	October 2,	January 3,
	2016	2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$50,290	\$136,069
Accounts receivable, net	21,762	20,424
Inventories	195,217	165,434
Prepaid expenses and other current assets	24,500	23,288
Total current assets	291,769	345,215
Property and equipment, net of accumulated depreciation	577,409	494,067
Intangible assets, net of accumulated amortization	197,958	198,601
Goodwill	368,078	368,078
Other assets	20,138	19,003
Deferred income tax asset	—	1,400
Total assets	\$1,455,352	\$1,426,364
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$162,275	\$134,480
Accrued salaries and benefits	25,759	30,717
Other accrued liabilities	47,502	50,253
Current portion of capital and financing lease obligations	9,419	14,972
Total current liabilities	244,955	230,422
Long-term capital and financing lease obligations	115,426	115,500
Long-term debt	205,000	160,000
Other long-term liabilities	111,907	97,450
Deferred income tax liability	18,719	—
Total liabilities	696,007	603,372
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Undesignated preferred stock; \$0.001 par value; 10,000,000 shares		
	—	—
authorized, no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 200,000,000 shares authorized,	145	153
145,301,469 and 152,577,884 shares issued and outstanding,		

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

	October 2, 2016 and January 3, 2016, respectively	
Additional paid-in capital	594,281	577,393
Retained earnings	164,919	245,446
Total stockholders' equity	759,345	822,992
Total liabilities and stockholders' equity	\$1,455,352	\$1,426,364

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF OPERATIONS

(UNAUDITED)

(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	Thirteen Weeks Ended		Thirty-nine Weeks	
	October 2,		Ended	
	2016	September	October 2,	September
		27, 2015	2016	27, 2015
Net sales	\$1,035,801	\$903,069	\$3,060,685	\$2,662,728
Cost of sales, buying and occupancy	744,288	641,612	2,156,857	1,879,839
Gross profit	291,513	261,457	903,828	782,889
Direct store expenses	216,932	177,990	617,817	518,561
Selling, general and administrative expenses	29,664	27,075	91,482	74,492
Store pre-opening costs	3,446	1,825	11,625	7,105
Store closure and exit costs	24	167	159	1,711
Income from operations	41,447	54,400	182,745	181,020
Interest expense	(3,723)	(3,685)	(10,985)	(13,990)
Other income	135	171	326	345
Loss on extinguishment of debt	—	—	—	(5,481)
Income before income taxes	37,859	50,886	172,086	161,894
Income tax provision	(13,974)	(18,900)	(64,785)	(61,119)
Net income	\$23,885	\$31,986	\$107,301	\$100,775
Net income per share:				
Basic	\$0.16	\$0.21	\$0.72	\$0.66
Diluted	\$0.16	\$0.21	\$0.71	\$0.65
Weighted average shares outstanding:				
Basic	147,743	153,585	149,202	153,071
Diluted	150,024	155,952	151,568	155,841

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

		Common	Additional Paid In	Retained	Total Stockholders'
	Shares	Stock	Capital	Earnings	Equity
Balances at December 28, 2014	151,833,334	\$ 152	\$ 543,048	\$ 142,189	\$ 685,389
Net income	—	—	—	128,991	128,991
Issuance of shares under option plans	1,812,829	2	6,318	—	6,320
Repurchase and retirement of common stock	(1,068,279)	(1)	-	(25,734)	(25,735)
Excess tax benefit for exercise of options	—	—	20,009	—	20,009
Equity-based compensation	—	—	8,018	—	8,018
Balances at January 3, 2016	152,577,884	\$ 153	\$ 577,393	\$ 245,446	\$ 822,992
Net income	—	—	—	107,301	107,301
Issuance of shares under option plans	608,273	—	2,618	—	2,618
Repurchase and retirement of common stock	(8,169,510)	(8)	—	(187,828)	(187,836)
Excess tax benefit for exercise of options	—	—	3,948	—	3,948
Equity-based compensation	—	—	10,322	—	10,322
Balances at October 2, 2016	145,016,647	\$ 145	\$ 594,281	\$ 164,919	\$ 759,345

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(IN THOUSANDS)

	Thirty-nine Weeks Ended October 2,	
	2016	September 27, 2015
Cash flows from operating activities		
Net income	\$ 107,301	\$ 100,775
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	59,997	50,665
Accretion of asset retirement obligation and closed facility reserve	237	251
Amortization of financing fees and debt issuance costs	347	617
Loss on disposal of property and equipment	226	1,257
Equity-based compensation	10,322	4,776
Loss on extinguishment of debt	—	5,481
Deferred income taxes	20,119	3,155
Changes in operating assets and liabilities:		
Accounts receivable	(1,336)	(11,150)
Inventories	(29,784)	(18,996)
Prepaid expenses and other current assets	(1,212)	(25)
Other assets	(1,480)	(444)
Accounts payable	24,050	28,641
Accrued salaries and benefits	(4,959)	(6,251)
Other accrued liabilities	(2,762)	(370)
Other long-term liabilities	14,971	20,709
Cash flows from operating activities	196,037	179,091
Cash flows from investing activities		
Purchases of property and equipment	(142,571)	(97,390)
Proceeds from sale of property and equipment	662	49
Purchase of leasehold interests	(491)	—
Cash flows used in investing activities	(142,400)	(97,341)
Cash flows from financing activities		
Proceeds from revolving credit facility	45,000	260,000
Payments on revolving credit facility	—	(100,000)
Payments on term loan	—	(261,250)
Payments on capital lease obligations	(531)	(492)
Payments on financing lease obligations	(2,613)	(2,575)
Payments of deferred financing costs	—	(1,896)
Repurchase of common stock	(187,836)	—
Excess tax benefit for exercise of stock options	3,948	19,584

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

Proceeds from the exercise of stock options	2,616	6,366
Cash flows used in financing activities	(139,416)	(80,263)
(Decrease) / Increase in cash and cash equivalents	(85,779)	1,487
Cash and cash equivalents at beginning of the period	136,069	130,513
Cash and cash equivalents at the end of the period	\$50,290	\$132,000

Supplemental disclosure of cash flow information

Cash paid for interest	\$10,942	\$14,174
Cash paid for income taxes	38,142	35,075

Supplemental disclosure of non-cash investing and financing

activities

Property and equipment in accounts payable	\$19,919	\$11,141
Property acquired through capital and financing lease obligations	8,324	9,899

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements include the accounts of the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial statements and are in the form prescribed by the Securities and Exchange Commission in instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company's financial position, results of operations and cash flows for the periods indicated. All material intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for any other interim period or for a full fiscal year. The information included in these consolidated financial statements and notes thereto should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included herein and Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto for the fiscal year ended January 3, 2016 ("fiscal year 2015") included in the Company's Annual Report on Form 10-K, filed on February 25, 2016.

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

The Company reports its results of operations on a 52- or 53-week fiscal calendar ending on the Sunday closest to December 31. The fiscal year ending January 1, 2017 ("fiscal year 2016") is a 52-week year, and fiscal year 2015 was a 53-week year. The Company reports its results of operations on a 13-week quarter, except for 53-week fiscal years.

The Company has one reportable and one operating segment.

The Company's business is subject to modest seasonality. Average weekly sales fluctuate throughout the year and are typically highest in the first half of the fiscal year. Produce, which contributed 25% of the Company's net sales for the thirty-nine weeks ended October 2, 2016, is generally more available in the first six months of the fiscal year due to the timing of peak growing seasons.

All dollar amounts are in thousands, unless otherwise noted.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

2. Recently Issued Accounting Pronouncements

In May 2014, the FASB issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers.” ASU No. 2014-09 provides guidance for revenue recognition. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, and estimating the amount of variable consideration to include in the transaction price attributable to each separate performance obligation. Subsequent to the initial standards, the FASB has also issued several ASUs to clarify specific revenue recognition topics. This guidance will be effective for the Company for its fiscal year 2018, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance.

In April 2015, the FASB issued ASU No. 2015-03, “Simplifying the Presentation of Debt Issuance Costs.” ASU No. 2015-03 requires an entity to present debt issuance costs in the balance sheet as a direct deduction from the related debt liability rather than as an asset. Amortization of the costs will continue to be reported as interest expense. This guidance is effective for the Company for its fiscal year 2016. The new guidance has been applied retrospectively to each prior period presented, and the adoption did not have a material effect on the Company’s consolidated financial statements.

In April 2015, the FASB issued ASU No. 2015-05, “Customer's Accounting for Fees Paid in a Cloud Computing Arrangement.” ASU No. 2015-05 provides guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If the arrangement does not include a software license, the customer should account for a cloud computing arrangement as a service contract. This guidance is effective for the Company for its fiscal year 2016. The Company adopted this amendment prospectively and the adoption did not have a material effect on its consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, “Simplifying the Measurement of Inventory.” ASU No. 2015-11 changes the measurement principle for inventory from the lower of cost or market to lower of cost and net realizable value. Net realizable value is defined as the estimated selling prices in the ordinary course of business; less reasonably predictable costs of completion, disposal and transportation. This guidance will be effective for the Company for its fiscal year 2017. The Company is currently evaluating the potential impact of this guidance.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (ASC 842).” ASU No. 2016-02 requires lessees to recognize a right-of-use asset and corresponding lease liability for all leases with terms greater than twelve months. Recognition, measurement and presentation of expenses will depend on classification as a finance or operating lease. The new guidance also requires certain additional quantitative and qualitative disclosures. This guidance will be effective for the Company for its fiscal year 2019, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance.

In March 2016, the FASB issued ASU No. 2016-04, “Liabilities-Extinguishments of Liabilities (Subtopic 405-20): Recognition of breakage for certain prepaid stored-value products.” ASU No. 2016-04 provides a narrow scope exception to the guidance in Subtopic 405-20 to require that stored-value breakage be accounted for consistently with the breakage guidance in Topic 606. The amendments in this update contain specific guidance for derecognition of prepaid stored-value product liabilities, thereby eliminating the current and potential future diversity. This guidance will be effective for the Company for its fiscal year 2019, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation – Stock Compensation (Topic 718).” This update involves several aspects of the accounting for share-based transactions, including the

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

income tax consequences, classification of awards as either equity or liabilities, how to account for forfeitures, and classification on the statement of cash flows. The amendments in this update are effective for the Company for its fiscal year 2017, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments". This update provides clarifications on the cash flow classification for eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. The guidance will be effective for the Company for its fiscal year 2018, with early adoption permitted. The Company is currently evaluating the potential impact of this guidance.

No other new accounting pronouncements issued or effective during the thirty-nine weeks ended October 2, 2016 had, or are expected to have, a material impact on the Company's consolidated financial statements.

3. Fair Value Measurements

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

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

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

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

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

The determination of fair values of certain tangible and intangible assets for purposes of the Company's goodwill impairment evaluation as described above was based upon a step zero assessment. Closed facility reserves are recorded at net present value to approximate fair value which is classified as Level 3 in the hierarchy. The estimated

fair value of the closed facility reserve is calculated based on the present value of the remaining lease payments and other charges using a weighted average cost of capital, reduced by estimated sublease rentals. The weighted average cost of capital was estimated using information from comparable companies and management's judgment related to the risk associated with the operations of the stores.

Cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable, accrued salaries and benefits and other accrued liabilities approximate fair value because of the short maturity of those instruments. Based on open market transactions comparable to the Credit Facility (as defined in Note 6, "Long-Term Debt"), the fair value of the long-term debt approximates carrying value as of October 2, 2016 and January 3, 2016. The Company's estimates of the fair value of long-term debt were classified as Level 2 in the fair value hierarchy.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

4. Accounts Receivable

A summary of accounts receivable is as follows:

	As of	
	October	January
	2,	3,
	2016	2016
Vendor	\$14,268	\$11,649
Receivables from landlords	830	4,143
Other	6,664	4,632
Total	\$21,762	\$20,424

The Company had recorded allowances for certain vendor receivables of \$0.1 million at both October 2, 2016 and January 3, 2016.

5. Accrued Salaries and Benefits

A summary of accrued salaries and benefits is as follows:

	As of	
	October	January
	2,	3,
	2016	2016
Accrued payroll	\$12,162	\$10,988
Vacation	10,831	8,916
Bonus	1,929	9,728
Other	837	1,085
Total	\$25,759	\$30,717

6. Long-Term Debt

A summary of long-term debt is as follows:

Facility	Maturity	Interest Rate	As of	
			October 2, 2016	January 3, 2016
Senior secured debt				
\$450.0 million Credit Facility	April 17, 2020	Variable	\$ 205,000	\$ 160,000
Total debt			205,000	160,000
Long-term debt			\$ 205,000	\$ 160,000

Senior Secured Revolving Credit Facility

April 2015 Refinancing

On April 17, 2015, the Company's subsidiary, Sprouts Farmers Markets Holdings, LLC ("Intermediate Holdings"), as borrower, entered into a credit agreement (the "Credit Agreement") to replace the Company's former credit facility and term loan. The Credit Agreement provides for a revolving credit facility with an initial aggregate commitment of \$450.0 million (the "Credit Facility"), which may be increased from time to time pursuant to an expansion feature set forth in the Credit Agreement.

Concurrently with the closing of the Credit Agreement, the Company borrowed \$260.0 million to pay off its \$257.8 million former term loan (the "April 2015 Refinancing"), and to terminate all commitments under its existing senior secured revolving credit facility, dated April 23, 2013, and to pay transaction costs related to the April 2015 Refinancing. Such repayment resulted in a \$5.5 million loss on extinguishment of debt due to the write-off of deferred financing costs and original issue discount. The remaining proceeds of loans made under the Credit Facility were used for general corporate purposes.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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

The Credit Agreement also provides for a letter of credit subfacility and a \$15.0 million swingline facility. Letters of credit issued under the Credit Agreement reduce the borrowing capacity of the Credit Facility. Letters of credit totaling \$1.7 million have been issued as of October 2, 2016, primarily to support the Company's insurance programs.

Borrowings

During the thirteen weeks ended October 2, 2016, the Company borrowed a total of \$45.0 million under the Credit Facility to be used in connection with the Company's \$250 million share repurchase program (see Note 11). The Company did not make any additional borrowings during the thirteen and thirty-nine weeks ended September 27, 2015.

Guarantees

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

Interest and Fees

Loans under the Credit Facility bear interest, at the Company's option, either at adjusted LIBOR plus 1.25% per annum, or a base rate plus 0.25% per annum. The interest rate margins are subject to adjustment pursuant to a pricing grid based on the Company's total gross leverage ratio, as defined in the Credit Agreement. Under the terms of the Credit Agreement, the Company is obligated to pay a commitment fee on the available unused amount of the Credit Facility commitments equal to 0.15% per annum.

Outstanding letters of credit under the Credit Facility are subject to a participation fee of 1.25% per annum and an issuance fee of 0.125% per annum.

Payments and Borrowings

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

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

Following the closing of the Credit Facility and the initial borrowing of \$260.0 million during 2015, the Company made a total of \$100.0 million of principal payments on the Credit Facility. During the thirteen weeks ended October 2, 2016, the Company borrowed an additional \$45.0 million; resulting in total outstanding debt under the Credit

Facility of \$205.0 million as of October 2, 2016.

Covenants

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

- incur additional indebtedness;
- grant additional liens;
- enter into sale-leaseback transactions;

9

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

- make loans or investments;
- merge, consolidate or enter into acquisitions;
- pay dividends or distributions;
- enter into transactions with affiliates;
- enter into new lines of business;
- modify the terms of debt or other material agreements; and
- change its fiscal year.

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

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

The Company was in compliance with all applicable covenants under the Credit Agreement as of October 2, 2016.

7. Closed Facility Reserves

The following is a summary of closed facility reserve activity during the thirty-nine weeks ended October 2, 2016 and fiscal year ended January 3, 2016:

	October 2,	January 3,
	2016	2016
Beginning balance	\$ 2,017	\$ 1,785
Additions	—	1,144
Usage	(860)	(1,332)
Adjustments	43	420
Ending balance	\$ 1,200	\$ 2,017

Usage during 2016 relates to lease payments made during the period for closed stores. Additions made during 2015 include remaining lease payments for the corporate support office relocation, and usage during 2015 primarily related to lease payments made during the year for closed stores.

8. Income Taxes

The Company's effective tax rate for the thirteen weeks ended October 2, 2016 and September 27, 2015 was 36.9% and 37.1%, respectively. The decrease in the effective tax rate is mainly related to an increase in the enhanced deduction for charitable donations of food inventory, partially offset by an increase in the effective state income tax rate.

The Company's effective tax rate for the thirty-nine weeks ended October 2, 2016 and September 27, 2015 was 37.7% and 37.8%, respectively.

Excess tax benefits associated with stock option exercises and vested restricted stock units are credited to stockholders' equity. The Company uses the tax law ordering approach of intraperiod allocation to allocate the benefit of windfall tax benefits based on provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes. The income tax benefits resulting from stock awards that were credited to stockholders' equity were \$3.9 million for the thirty-nine weeks ended October 2, 2016. The excess tax benefits are not credited to stockholders' equity until the deduction reduces income taxes payable.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

9. Related-Party Transactions

A member of the Company's board of directors is an investor in a company that is a supplier of coffee to the Company. During the thirteen weeks ended October 2, 2016 and September 27, 2015, purchases from this supplier were \$2.1 million and \$2.3 million, respectively. During the thirty-nine weeks ended October 2, 2016 and September 27, 2015, purchases from this company were \$7.3 million and \$7.1 million, respectively. At October 2, 2016 and September 27, 2015, the Company had recorded accounts payable due to this supplier of \$0.7 million and \$0.7 million, respectively.

The Company's Executive Chairman of the Board is the chief executive officer, an equity investor, and lender to a technology supplier to the Company. During the thirteen weeks ended October 2, 2016 and September 27, 2015, purchases from this supplier and its predecessors were \$2.2 million and \$1.9 million, respectively. During the thirty-nine weeks ended October 2, 2016 and September 27, 2015, purchases from this supplier and its predecessors were \$6.0 million and \$5.2 million, respectively. At October 2, 2016 and September 27, 2015, the Company had recorded accounts payable due to the supplier of \$0.5 million and \$0.2 million, respectively.

10. Commitments and Contingencies

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

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against the Company and certain of its directors and officers on behalf of a purported class of purchasers of shares of the Company's common stock in the Company's underwritten secondary public offering which closed on March 10, 2015 (the "March 2015 Offering"). The complaint purports to state claims under Sections 11, 12 and 15 of the Securities Act of 1933, as amended, based on an alleged failure by the Company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint seeks damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. On March 24, 2016, the Company removed the action to federal court in the District of Arizona. On April 18, 2016, the Company filed a motion to remand the case to state court, and that motion is currently under consideration. The Company intends to defend this case vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the case.

11. Stockholders' Equity

Share Repurchase

On November 4, 2015, the Company's board of directors authorized a \$150 million share repurchase program for its common stock, which was completed during the thirteen weeks ended July 3, 2016. On September 6, 2016, the Company's board of directors authorized a new \$250 million share repurchase program for its common stock. The following table outlines the share repurchase programs authorized by the Board, and the related repurchase activity and available authorization as of October 2, 2016.

Effective date	Expiration date	Amount authorized	Cost of repurchases	Authorization available
November 4, 2015	Not applicable	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	250,000	63,572	186,428

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

The shares under the Company's repurchase programs may be purchased on a discretionary basis from time to time prior to the applicable expiration date, subject to general business and market conditions and other investment opportunities, through open market purchases, privately negotiated transactions, or other means, including through Rule 10b5-1 trading plans. The board's authorization of the share repurchase programs does not obligate the Company to acquire any particular amount of common stock, and the repurchase programs may be commenced, suspended, or discontinued at any time. The Company has used borrowings under its Credit Facility to assist with the repurchase program authorized on September 6, 2016 (see Note 6).

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	October 2,	September 27,	October 2,	September 27,
	2016	2015	2016	2015
Number of common shares acquired	3,189,818	-	8,169,510	-
Average price per common share acquired	\$19.93	-	\$22.99	-
Total cost of common shares acquired	\$63,572	-	\$187,836	-

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

12. Net Income Per Share

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

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

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

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Basic net income per share:				
Net income	\$23,885	\$31,986	\$107,301	\$100,775
Weighted average shares outstanding	147,743	153,585	149,202	153,071
Basic net income per share	\$0.16	\$0.21	\$0.72	\$0.66
Diluted net income per share:				
Net income	\$23,885	\$31,986	\$107,301	\$100,775
Weighted average shares outstanding	147,743	153,585	149,202	153,071
Dilutive effect of equity-based awards:				
Assumed exercise of options to purchase shares	2,200	2,360	2,278	2,739
RSUs	28	7	49	31
RSAs	13	—	9	—
PSAs	40	—	30	—
Weighted average shares and equivalent				
shares outstanding	150,024	155,952	151,568	155,841
Diluted net income per share	\$0.16	\$0.21	\$0.71	\$0.65

For the thirteen weeks ended October 2, 2016, the computation of diluted net income per share does not include 2.2 million options, 0.1 million RSUs, and 0.1 million PSAs as those awards would have

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

been antidilutive or were unvested performance awards. For the thirteen weeks ended September 27, 2015, the computation of diluted net income per share does not include 2.9 million options, 0.1 million RSUs, and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards.

For the thirty-nine weeks ended October 2, 2016, the computation of diluted net income per share does not include 1.3 million options, 0.1 million RSUs, and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards. For the thirty-nine weeks ended September 27, 2015, the computation of diluted net income per share does not include 0.8 million options and 0.1 million PSAs as those awards would have been antidilutive or were unvested performance awards,

13. Equity-Based Compensation

2013 Incentive Plan

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

The aggregate number of shares of common stock that may be issued to team members and directors under the 2013 Incentive Plan may not exceed 10,089,072. Shares subject to awards granted under the 2013 Incentive Plan which are subsequently forfeited, expire unexercised or are otherwise not issued will not be treated as having been issued for purposes of the share limitation. At October 2, 2016, there were 3,588,916 stock awards outstanding and 6,292,391 shares remaining available for issuance under the 2013 Incentive Plan.

2011 Option Plan

In May 2011, the Company adopted the 2011 Option Plan to provide team members or directors of the Company with options to acquire shares of the Company. The Company had authorized 12,100,000 shares for issuance under the 2011 Option Plan. Options may no longer be issued under the 2011 Option Plan. At October 2, 2016, there were 3,854,113 options outstanding under the 2011 Option Plan.

Awards Granted

During the thirty-nine weeks ended October 2, 2016, the Company granted the following stock-based compensation awards:

Grant Date	Stock			
	Options	RSUs	PSAs	RSAs
March 4, 2016	318,156	213,767	92,942	—
April 11, 2016	4,627	1,335	—	—
May 9, 2016	—	14,404	—	—
May 23, 2016	419,935	—	—	217,852
August 18, 2016	—	7,499	—	—
Total:	742,718	237,005	92,942	217,852
Weighted-average grant date fair value	\$7.43	\$27.93	\$28.21	\$24.48
Weighted-average exercise price	\$26.10	—	—	—

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

Options

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

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

RSUs

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

PSAs

PSAs granted in 2015 are restricted shares that were subject to the Company achieving certain earnings per share performance targets, as well as additional time-vesting conditions. The fair value of PSAs is based on the closing price of the Company's common stock on the grant date. During the thirty-nine weeks ended October 2, 2016, the performance conditions with respect to 2015 earnings per share were deemed to have been met, and the PSAs will vest 50 percent at each of the second and third anniversary of the grant date.

PSAs granted in 2016 are restricted shares that are subject to the Company achieving certain earnings before interest and taxes ("EBIT") performance targets on an annual and cumulative basis over a three-year performance period, as well as additional time-vesting conditions. The fair value of these PSAs is based on the closing price of the Company's common stock on the grant date. The EBIT target resets annually for each of the three years during the performance period based on a percentage increase over the previous year's actual EBIT, with each annual performance tranche independent of the previous and next tranche. Cumulative performance is based on the aggregate annual performance targets. Payout of the performance shares will either be 0% or range from 50% to 150% of the target number of shares granted. If the performance conditions are met, PSAs cliff vest on the third anniversary of the grant date.

RSAs

The fair value of RSAs is based on the closing price of the Company's common stock on the grant date. RSAs will vest either ratably over a seven quarter period, beginning on December 31, 2016 or cliff vest on June 30, 2018.

Equity Award Revisions

In connection with the appointments of the Company's Chief Executive Officer and President & Chief Operating Officer in August 2015, the Compensation Committee of the Company's Board of Directors approved a grant of stock options to purchase 1,200,000 and 500,000 shares of the Company's common stock at an exercise price of \$20.98 per share to these officers, respectively (the "August 2015 Options") pursuant to the 2013 Incentive Plan. The August 2015 Options, taken together with other options granted under the 2013 Incentive Plan to such officers during 2015,

exceeded the limit of 500,000 shares which may be granted pursuant to stock options and stock appreciation rights per calendar year to each participant under the 2013 Incentive Plan by 733,439 shares in the case of the Company's Chief Executive Officer and 33,439 shares in the case of the Company's President & Chief Operating Officer (the "Excess Options"). Accordingly, the Company has determined, and these officers have acknowledged, that the grants of the Excess Options were null and void.

In order to satisfy the original intent with respect to these individuals' compensation, on May 23, 2016, the Compensation Committee granted to the Company's Chief Executive Officer and President & Chief Operating Officer under the 2013 Incentive Plan options to purchase 386,496 and 33,439 shares of the Company's common stock at an exercise price of \$24.48 per share, respectively, and 215,251 and

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

2,601 RSAs, respectively. The Company recognized compensation expense of \$1.0 million during the thirteen weeks ended October 2, 2016 related to the options and RSAs granted.

Equity-based Compensation Expense

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

	Thirteen Weeks Ended		Thirty-nine Weeks Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Cost of sales, buying and occupancy	\$244	\$ 187	\$726	\$ 418
Direct store expenses	339	294	1,015	762
Selling, general and administrative expenses	3,414	1,861	8,581	3,594
Equity-based compensation expense before income taxes	3,997	2,342	10,322	4,774
Income tax benefit	(1,519)	(885)	(3,922)	(1,804)
Net equity-based compensation expense	\$2,478	\$ 1,457	\$6,400	\$ 2,970

The following equity-based awards were outstanding as of October 2, 2016 and January 3, 2016:

	As of	
	October 2, 2016	January 3, 2016
	(in thousands)	(in thousands)
Options		
Vested	5,401	5,287
Unvested	1,385	2,116
RSUs	280	143
PSAs	159	70
RSAs	218	—

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

As of October 2, 2016 total unrecognized compensation expense related to outstanding equity-based awards was as follows:

	As of October 2, 2016
Options	\$8,860
RSUs	5,810
PSAs	2,200
RSAs	4,416
Total unrecognized compensation expense	\$21,286

As of October 2, 2016, the total remaining weighted average recognition period related to outstanding equity-based awards was as follows:

	As of October 2, 2016
Options	1.8
RSUs	1.7
PSAs	1.8
RSAs	1.7

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

During the thirty-nine weeks ended October 2, 2016 and September 27, 2015, the Company received \$2.6 million and \$6.4 million, respectively, in cash proceeds from the exercise of options.

14. Subsequent Events

Subsequent to October 2, 2016, and through October 31, 2016, the Company repurchased an additional 2.9 million shares of common stock for \$60.9 million. The Company borrowed an additional \$60.0 million under its Credit Facility that was utilized in these repurchases, resulting in total outstanding debt under the Credit Facility of \$265 million as of October 31, 2016.

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

You should read the following discussion of our financial condition and results of operations in conjunction with the consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K filed February 25, 2016 with the Securities and Exchange Commission. All dollar amounts included below are in thousands, unless otherwise noted.

Business Overview

Sprouts Farmers Market operates as a healthy grocery store that offers fresh, natural and organic food that includes fresh produce, bulk foods, vitamins and supplements, packaged groceries, meat and seafood, deli, baked goods, dairy products, frozen foods, body care and natural household items catering to consumers’ growing interest in health and wellness. Since our founding in 2002, we have grown rapidly, significantly increasing our sales, store count and profitability. With 250 stores in 13 states as of October 2, 2016, we are one of the largest specialty retailers of fresh, natural and organic food in the United States.

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

Healthy Living for Less. We offer high-quality, fresh, natural and organic products at attractive prices in every department. Consistent with our farmers market heritage, our offering begins with fresh produce, which we source, warehouse and distribute in-house and sell at prices we believe to be significantly below those of other food retailers. In addition, our scale, operating structure and deep industry relationships position us to consistently deliver competitive prices and promote value throughout the store. Based on our experience, we believe we attract a broad customer base, including conventional supermarket customers, and appeal to a much wider demographic than other specialty retailers of natural and organic food. We believe that over time, our compelling prices and product offering convert many “trial” customers into loyal “lifestyle” customers who shop Sprouts with greater frequency and across an increasing number of departments.

Attractive, Differentiated Shopping Experience. In a convenient, small-box format (average store size of 28,000 to 30,000 sq. ft.), our stores have a farmers market feel, with a bright, open-air atmosphere to create a comfortable and engaging in-store experience. We strive to be our customers’ everyday healthy grocery store. We feature fresh produce and bulk foods at the center of the store surrounded by a complete grocery offering. Consistent with our fresh, natural and organic offering, we choose not to carry most of the traditional, national branded consumer packaged goods generally found at conventional grocery retailers (e.g., Doritos, Tide and Lucky Charms). Instead, we offer high-quality, and innovative healthier alternatives that emphasize our focus on fresh, natural and organic products at great values.

Customer Engagement and Education. Our commitment to “Healthy Living for Less” is shared by team members throughout the entire organization who are dedicated to our passion for educating and engaging with our customers with the goal of making healthy eating easier and more accessible. We believe our well-trained and engaged team members, as well as the materials we disseminate through our digital and social media platforms, help our customers increasingly understand that they can purchase a wide selection of high-quality, healthy, and great tasting food for themselves and their families at attractive prices by shopping at Sprouts.

Outlook

We are pursuing a number of strategies designed to continue our growth, including expansion of our store base, continuing positive comparable store sales growth and growing the Sprouts brand. We intend to continue expanding our store base by pursuing new store openings in our existing markets,

17

expanding into adjacent markets and penetrating new markets. We opened 27 stores and relocated one store during 2015. We expect to continue to expand our store base with 36 store openings planned in fiscal 2016, of which 35 have opened as of the date of this Quarterly Report on Form 10-Q. Although we plan to expand our store base primarily through new store openings, we may grow through strategic acquisitions if we identify suitable targets and are able to negotiate acceptable terms and conditions for acquisition. We aim to achieve 14% annual new store growth for at least the next five years.

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

Our History

In 2002, we opened the first Sprouts Farmers Market store in Chandler, Arizona. From our founding in 2002 through January 3, 2016, we continued to open new stores while successfully rebranding 43 Henry's Farmers Market (referred to as "Henry's") and 39 Sunflower Farmers Market (referred to as "Sunflower") stores added through acquisitions to the Sprouts banner (referred to as the "Transactions"). These three businesses all trace their lineage back to Henry's Farmers Market and were built with similar store formats and operations including a strong emphasis on value, produce and service in smaller, convenient locations. The consistency of these formats and operations was an important factor that allowed us to rapidly and successfully rebrand and integrate each of these businesses under the Sprouts banner and on a common platform. Since our August 2013 initial public offering, we have continued to expand, adding stores in our existing markets and extending into Kansas, Georgia, Missouri, Alabama and Tennessee.

Components of Operating Results

We report our results of operations on a 52- or 53-week fiscal year ending on the Sunday closest to December 31, with each fiscal quarter generally divided into three periods consisting of two four-week periods and one five-week period. The third quarter of fiscal years 2016 and 2015 were thirteen-week periods ended October 2, 2016 and September 27, 2015, respectively.

Net sales

We recognize sales revenue at the point of sale, with discounts provided to customers reflected as a reduction in sales revenue. Proceeds from sales of gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer. In the second quarter of 2015, we determined that we had sufficient data to estimate gift card breakage. We record an allowance for breakage on gift cards based on historical experience. We do not include sales taxes in net sales.

We monitor our comparable store sales growth to evaluate and identify trends in our sales performance. Our practice is to include sales from a store in comparable store sales beginning on the first day of the 61st week following the store's opening and to exclude sales from a closed store from comparable store sales beginning on the day of closure. We include sales from an acquired store in comparable store sales on the later of (i) the day of acquisition or (ii) the first day of the 61st week following the store's opening. We also include sales from relocated stores immediately after relocation. These practices may differ from the methods that other retailers use to calculate similar measures.

Net sales are affected by store openings and closings and comparable store sales growth. Factors that influence comparable store sales growth and other sales trends include:

- general economic conditions and trends, including levels of disposable income and consumer confidence;
- consumer preferences and buying trends;

18

- our ability to identify market trends, and to source and provide product offerings that promote customer traffic and growth in average ticket;

the number of customer transactions and average ticket;

the prices of our products, including the effects of inflation and deflation;

opening new stores in the vicinity of our existing stores;

advertising, in-store merchandising and other marketing activities; and

our competition, including competitive store openings in the vicinity of our stores and competitor pricing and merchandising strategies.

Cost of sales, buying and occupancy and gross profit

Cost of sales includes the cost of inventory sold during the period, including direct costs of purchased merchandise (net of discounts and allowances), distribution and supply chain costs, buying costs and supplies. Merchandise incentives received from vendors are reflected in the carrying value of inventory when earned or as progress is made toward earning the rebate or allowance, and are reflected as a component of cost of sales as the inventory is sold. Inflation and deflation in the prices of food and other products we sell may affect our gross profit. The impact of inflation and deflation is largely dependent on whether or not we pass the effects through to our customers, which will depend upon competitive market conditions.

Occupancy costs include store rental, property taxes, utilities, common area maintenance, amortization of favorable and unfavorable leasehold interests and property insurance. Occupancy costs do not include building depreciation, which is classified as a direct store expense.

Gross profit is equal to our net sales less our cost of sales, buying and occupancy. Gross margin is gross profit as a percentage of our net sales.

Our cost of sales, buying and occupancy and gross profit are correlated to sales volumes. Gross margin is affected by the relative mix of products sold, pricing strategies, inventory shrinkage and fixed costs of sales, buying and occupancy.

Direct store expenses

Direct store expenses consist of store-level expenses such as salaries and benefits, related equity-based compensation, supplies, depreciation and amortization for buildings, store leasehold improvements, equipment and other store specific costs.

Selling, general and administrative expenses

Selling, general and administrative expenses primarily consist of salaries and benefits costs, equity-based compensation, advertising and corporate overhead.

We charge third-parties to place advertisements in our in-store guide and newspaper circulars. We record consideration received from vendors in connection with cooperative advertising programs as a reduction to advertising costs when the allowance represents reimbursement of a specific and identifiable cost. Advertising costs are expensed as incurred.

Store pre-opening costs

Store pre-opening costs include rent expense during construction of new stores and costs related to new store openings, including costs associated with hiring and training personnel and other miscellaneous costs. Store

pre-opening costs are expensed as incurred.

Store closure and exit costs

We recognize a reserve for future operating lease payments and other occupancy costs associated with facilities that are no longer being utilized in our current operations. The reserve is

19

recorded based on the present value of the remaining non-cancelable lease payments and estimates of other occupancy costs after the cease use date less a discounted estimate of subtenant income. If subtenant income is expected to be higher than the lease payments, no accrual is recorded. Lease payments and other occupancy costs included in the closed facility reserve are expected to be paid over the remaining terms of the respective leases. Our assumptions about subtenant income are based on our experience and knowledge of the area in which the closed property is located, guidance received from local brokers and agents and existing economic conditions. Adjustments to the closed facility reserve relate primarily to changes in actual or estimated subtenant income and changes in actual lease payments and other occupancy costs from original estimates. Adjustments are made for changes in estimates in the period in which the change becomes known, considering timing of new information regarding market, subleases or other lease updates. Changes in reserve estimates are classified as store closure and exit costs in the consolidated statements of operations.

Provision for income taxes

We must make certain estimates and judgments in determining income tax expense for financial statement purposes. The amount of taxes currently payable or refundable is accrued and deferred tax assets and liabilities are recognized for the estimated future tax consequences attributable to differences between the financial statement carrying amount of existing assets and liabilities and their respective tax bases. Deferred tax assets are also recognized for realizable loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates in effect for the year in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in income tax rates is recognized in our financial statements in the period that includes the enactment date.

Results of Operations for Thirteen Weeks Ended October 2, 2016 and September 27, 2015

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

	Thirteen weeks ended October 2, 2016		September 27, 2015
Unaudited Quarterly Consolidated Statement of Operations Data:			
Net sales	\$1,035,801		\$ 903,069
Cost of sales, buying and occupancy	744,288		641,612
Gross profit	291,513		261,457
Direct store expenses	216,932		177,990
Selling, general and administrative expenses	29,664		27,075
Store pre-opening costs	3,446		1,825
Store closure and exit costs	24		167
Income from operations	41,447		54,400
Interest expense	(3,723)		(3,685)
Other income	135		171
Income before income taxes	37,859		50,886
Income tax provision	(13,974)		(18,900)
Net income	\$23,885		\$ 31,986

	Thirteen weeks ended October 2, 2016		September 27, 2015
Comparable store sales growth(1)	1.3 %		5.8 %

Other Operating Data:		
Stores at beginning of period	240	208
Opened	10	8
Stores at end of period	250	216

(1) See the explanation of “Comparable store sales growth” above under “Components of Operating Results – Net sales.” Comparison of Thirteen Weeks Ended October 2, 2016 to Thirteen Weeks Ended

September 27, 2015

Net sales

	Thirteen weeks ended			
	October 2,	September		
	2016	27, 2015	Change	% Change
Net sales	\$1,035,801	\$903,069	\$132,732	15 %
Comparable store sales growth	1.3	% 5.8	%	

Net sales for the thirteen weeks ended October 2, 2016 totaled \$1.0 billion, increasing 15% over the same period of the prior fiscal year. Sales growth was driven by strong performance in new stores opened and increases in comparable store sales. Comparable stores contributed approximately 87% of total sales for the thirteen weeks ended October 2, 2016 and approximately 86% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirteen weeks ended		Change	Change	
	October 2, 2016	September 27, 2015			%
Net sales	\$1,035,801	\$903,069	\$132,732	15	%
Cost of sales, buying and occupancy	744,288	641,612	102,676	16	%
Gross profit	291,513	261,457	30,056	11	%
Gross margin	28.1	% 28.9	% (0.8)		%

Cost of sales, buying and occupancy increased during the thirteen weeks ended October 2, 2016 compared to the thirteen weeks ended September 27, 2015, primarily due to the increase in sales from new store openings and comparable store sales growth, as discussed above. Gross profit increased \$30.1 million primarily as a result of new store sales. The gross margin percentage decrease reflects 60 basis points from increased price investments in certain categories in response to the ongoing deflationary and promotional environment, and slightly higher shrink from lower comp sales, with an additional 20 basis points of deleverage from occupancy.

Direct store expenses

	Thirteen weeks ended		Change	Change	
	October 2, 2016	September 27, 2015			%
Direct store expenses	\$216,932	\$177,990	\$38,942	22	%
Percentage of net sales	20.9	% 19.7	% 1.2		%

Direct store expenses as a percentage of sales for the quarter increased 120 basis points to 20.9% compared to the same period in 2015. Thirty basis points of this increase related to cycling a lower medical benefit expense from the prior year. The remaining increase was primarily due to deleverage from lower comp sales growth, higher payroll expense from planned increases in wages and training costs implemented at the beginning of the year, and the impact of opening a greater number of new stores in 2016.

Selling, general and administrative expenses

	Thirteen weeks ended		Change	Change	
	October 2, 2016	September 27, 2015			%
Selling, general and administrative expenses	\$29,664	\$27,075	\$2,589	10	%

Percentage of net sales	2.9	%	3.0	%	(0.1))%
-------------------------	-----	---	-----	---	-------	----

The increase in selling, general and administrative expenses included \$2.0 million in advertising to support new stores, \$1.5 million in equity-based compensation expense primarily due to additional grants related to management transitions during 2015, \$0.9 million in corporate payroll to support growth, \$0.3 million in consulting for strategic initiatives, and other less significant increases in expense. These increases were partially offset by \$2.2 million decrease in corporate bonus expense.

Store pre-opening costs

Store pre-opening costs were \$3.4 million for the thirteen weeks ended October 2, 2016 and \$1.8 million for the thirteen weeks ended September 27, 2015. Store pre-opening costs in the thirteen weeks ended October 2, 2016 included \$2.6 million related to opening 10 stores during that period and \$0.8 million associated with three stores expected to open subsequent to quarter end. Store pre-opening costs in the thirteen weeks ended September 27, 2015 included \$1.7 million related to opening eight stores during that period and \$0.1 million associated with one store opened subsequent to quarter end.

Interest expense

Interest expense was \$3.7 million for the thirteen weeks ended October 2, 2016, which is consistent with the \$3.7 million for the thirteen weeks ended September 27, 2015.

Income tax provision

Income tax provision decreased to \$13.9 million for the thirteen weeks ended October 2, 2016 from \$18.9 million for the thirteen weeks ended September 27, 2015, mainly related to a decrease in income before income taxes. Our effective income tax rate was 36.9% in the thirteen weeks ended October 2, 2016 and 37.1% in the thirteen weeks ended September 27, 2015. The decrease in the effective tax rate is mainly related to an increase in the enhanced deduction for charitable donations of food inventory and an increase in tax credits, partially offset by an increase in the effective state income tax rate.

Net income

	Thirteen weeks ended			
	October	September	Change	% Change
	2, 2016	27, 2015		
Net income	\$23,885	\$ 31,986	\$(8,101)	(25)%
Percentage of net sales	2.3 %	3.5 %	(1.2 %)	

The decline in net income was driven by a decrease in gross margin as a result of increased price investments in certain categories in response to the ongoing deflationary and competitive environment and increased store payroll and selling, general and administrative expenses.

Results of Operations for Thirty-nine Weeks Ended October 2, 2016 and September 27, 2015

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

	Thirty-nine Weeks Ended	
	October 2, 2016	September 27, 2015
Unaudited Quarterly Consolidated Statement of Operations		
Data:		
Net sales	\$3,060,685	\$2,662,728

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

Cost of sales, buying and occupancy	2,156,857	1,879,839
Gross profit	903,828	782,889
Direct store expenses	617,817	518,561
Selling, general and administrative expenses	91,482	74,492
Store pre-opening costs	11,625	7,105
Store closure and exit costs	159	1,711
Income from operations	182,745	181,020
Interest expense	(10,985)	(13,990)
Other income	326	345
Loss on extinguishment of debt	—	(5,481)
Income before income taxes	172,086	161,894
Income tax provision	(64,785)	(61,119)
Net income	\$107,301	\$100,775

	Thirty-nine Weeks Ended		
	October 2,	September 27,	
	2016	2015	
Comparable store sales growth(1)	3.4 %	5.2 %	

Other Operating Data:

Stores at beginning of period	217	191
Closed	—	(1)
Opened	33	26
Stores at end of period	250	216

(1) See the explanation of “Comparable store sales growth” above under “Components of Operating Results – Net sales.” Comparison of Thirty-Nine Weeks Ended October 2, 2016 to Thirty-nine Weeks Ended

September 27, 2015

Net sales

	Thirty-nine Weeks Ended				
	October 2, 2016	September 27, 2015	Change	% Change	
Net sales	\$3,060,685	\$2,662,728	\$397,957	15	%
Comparable store sales growth	3.4	% 5.2	%		

Net sales for the thirty-nine weeks ended October 2, 2016 totaled \$3.1 billion, increasing 15% over the same period of the prior fiscal year. Sales growth was primarily driven by solid performance in new stores opened. Comparable stores contributed approximately 88% of total sales for the thirty-nine weeks ended October 2, 2016 and approximately 86% for the same period of the prior fiscal year.

Cost of sales, buying and occupancy and gross profit

	Thirty-nine Weeks Ended				
	October 2, 2016	September 27, 2015	Change	% Change	
Net sales	\$3,060,685	\$2,662,728	\$397,957	15	%
Cost of sales, buying and occupancy	2,156,857	1,879,839	277,018	15	%
Gross profit	903,828	782,889	120,939	15	%
Gross margin	29.5	% 29.4	% 0.1	%	

Edgar Filing: Sprouts Farmers Market, Inc. - Form 10-Q

Cost of sales, buying and occupancy increased during the thirty-nine weeks ended October 2, 2016 compared to the thirty-nine weeks ended September 27, 2015, primarily due to the increase in sales from new store openings, as discussed above. Gross profit increased \$117.0 million as a result of increased sales volume, and \$3.9 million related to increased margin. The gross margin increase is due to higher margins in certain categories primarily due to deflation, partially offset by price investments in certain categories.

Direct store expenses

	Thirty-nine Weeks Ended			
	October 2, 2016	September 27, 2015	Change	% Change
Direct store expenses	\$617,817	\$518,561	\$99,256	19 %
Percentage of net sales	20.2 %	19.5 %	0.7 %	

Direct store expenses increased \$99.3 million, primarily due to stores opened since September 27, 2015, as well as increases in direct store expenses associated with stores operated prior to September

27, 2015. Direct store expenses, as a percentage of net sales, increased 70 basis points primarily due to higher payroll expense from planned wage increases and increased training costs.

Selling, general and administrative expenses

	Thirty-nine Weeks Ended			
	October 2, 2016	September 27, 2015	Change	% Change
Selling, general and administrative expenses	\$91,482	\$74,492	\$16,990	23%
Percentage of net sales	3.0%	2.8%	0.2%	

The increase in selling, general and administrative expenses included \$5.7 million in advertising to support new stores, \$5.0 million in equity-based compensation expense due to additional grants related to management transitions during 2015, \$3.2 million in corporate payroll to support growth, \$1.1 million in consulting for strategic initiatives, and other less significant increases in expense.

Store pre-opening costs

Store pre-opening costs were \$11.6 million for the thirty-nine weeks ended October 2, 2016 and \$7.1 million for the thirty-nine weeks ended September 27, 2015. Store pre-opening costs in the thirty-nine weeks ended October 2, 2016 included \$10.6 million related to opening 33 stores during the thirty-nine weeks and \$1.0 million associated with stores expected to open subsequent to quarter end. Store pre-opening costs in the thirty-nine weeks ended September 27, 2015 included \$6.9 million related to opening 26 stores during that period and \$0.2 million associated with one store opened subsequent to quarter end.

Store closure and exit costs

Store closure and exit costs of \$1.7 million for the thirty-nine weeks ended September 27, 2015 includes \$1.7 million for the relocation of our support office and adjustments for prior reserves.

Interest expense

Interest expense decreased to \$11.0 million for the thirty-nine weeks ended October 2, 2016 from \$14.0 million for the thirty-nine weeks ended September 27, 2015. The decrease in interest expense is due to the lower average principal balances on both the current Credit Facility and the Company's former revolving credit Facility combined with the lower interest rate on our Credit Facility following the April 2015 Refinancing.

Loss on extinguishment of debt

In the thirty-nine weeks ended September 27, 2015, we recorded a loss on extinguishment of debt totaling \$5.5 million related to the write-off of deferred financing costs and issue discount in the April 2015 Refinancing.

Income tax provision

Income tax provision increased to \$64.8 million for the thirty-nine weeks ended October 2, 2016 from \$61.1 million for the thirty-nine weeks ended September 27, 2015, mainly related to an increase in income before income taxes. Our effective income tax rate decreased to 37.7% in the thirty-nine weeks ended October 2, 2016 from 37.8% in the thirty-nine weeks ended September 27, 2015. The decrease in the effective tax rate is mainly related to an increase in the enhanced deduction for charitable donations of food inventory and an increase in tax credits, partially offset by an increase in the effective state income tax rate.

Net income

	Thirty-nine Weeks Ended		Change	% Change
	October 2, 2016	September 27, 2015		
Net income	\$107,301	\$100,775	\$6,526	6 %
Percentage of net sales	3.5 %	3.8 %	(0.3)%	

Net income growth was driven by sales growth, increased gross margin and loss on extinguishment of debt in prior year, offset by increases in advertising expense to support our growth, payroll and equity-based compensation expense.

Liquidity and Capital Resources

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

	Thirty-nine weeks ended	
	October 2, 2016	September 27, 2015
Cash and cash equivalents at end of period	\$50,290	\$132,000
Cash flows from operating activities	\$196,037	\$179,091
Cash flows used in investing activities	\$(142,400)	\$(97,341)
Cash flows used in financing activities	\$(139,416)	\$(80,263)

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

Operating activities

Cash flows from operating activities increased \$16.9 million to \$196.0 million for the thirty-nine weeks ended October 2, 2016 compared to \$179.1 million for the thirty-nine weeks ended September 27, 2015. The increase in operating cash flow is primarily due to the growth in cash flows from existing stores and from new stores opened

since the third quarter of 2015.

Investing activities

Cash flows used in investing activities were \$142.4 million for the thirty-nine weeks ended October 2, 2016 compared to \$97.3 million for the thirty-nine weeks ended September 27, 2015.

Capital expenditures consist primarily of investments in new stores, including leasehold improvements and store equipment, capital expenditures to maintain the appearance of our stores, sales enhancing initiatives and other corporate investments.

We expect capital expenditures to be in the range of \$160 - \$165 million in fiscal 2016, including expenditures incurred to date, net of estimated landlord tenant improvement allowances, primarily to fund investments in new stores, remodels, maintenance capital expenditures and corporate capital expenditures. We expect to fund our capital expenditures with cash on hand, cash generated from operating activities and, if required, borrowings under our Credit Facility.

Financing activities

Cash flows used in financing activities were \$139.4 million for the thirty-nine weeks ended October 2, 2016 compared to cash used in financing activities of \$80.3 million for the thirty-nine weeks ended September 27, 2015. During the thirty-nine weeks ended October 2, 2016, cash flows used in financing activities consisted of \$187.8 million for stock repurchases, \$3.1 million cash paid for capital and financing lease obligations, partially offset by \$45 million of borrowings on the revolving credit facility, \$3.9 million of excess tax benefit from the exercise of stock options and \$2.6 million in proceeds from the exercise of stock options. During the thirty-nine weeks ended September 27, 2015, cash flows used in financing activities consisted of \$261.3 million cash paid on the term loan, \$100 million repayment on the revolving credit facility, \$3.1 million cash paid for capital and financing lease obligations and \$1.9 million payments of deferred financing costs, partially offset by \$260 million borrowings on the revolving credit facility, \$19.6 million of excess tax benefits from the exercise of stock options and \$6.4 million in proceeds from the exercise of stock options.

Long-Term debt and credit facilities

See Note 6 “Long-Term Debt” of our unaudited consolidated financial statements for a description of our Credit Facility and our former credit facility.

Contractual Obligations

We are committed under certain capital leases for the rental of certain land and buildings and certain operating leases for rental of facilities and equipment. These leases expire or become subject to renewal clauses at various dates through 2035.

The following table summarizes our lease obligations as of October 2, 2016, and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	4-5 Years	More Than 5 Years
	(in thousands)				
Capital and financing lease obligations(1)	\$138,212	\$15,577	\$31,411	\$29,906	\$61,318
Operating lease obligations(1)	1,399,978	120,573	260,919	248,046	770,440
Totals	\$1,538,190	\$136,150	\$292,330	\$277,952	\$831,758

(1) Represents estimated payments for capital and financing and operating lease obligations as of October 2, 2016. Capital and financing lease obligations and operating lease obligations are presented gross without offset for subtenant rentals. We have subtenant agreements under which we will receive \$1.5 million for the period of less than one year, \$2.3 million for years one to three, \$1.6 million for years four to five, and \$1.7 million for the period beyond five years.

We have other contractual commitments and debt, which were presented under Contractual Obligations in our Annual Report on Form 10-K for the fiscal year ended January 3, 2016, and for which there have not been material changes since that filing through October 2, 2016. As discussed in Note 6 to the unaudited consolidated financial statements,

we entered into the Credit Facility with an initial balance of \$260.0 million which will mature in April 2020. As of October 2, 2016, the outstanding balance on the Credit Facility was \$205.0 million.

Off-Balance Sheet Arrangements

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

Impact of Inflation

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

Food inflation and deflation is affected by a variety of factors and our determination of whether to pass on the effects of inflation or deflation to our customers is made in conjunction with our overall pricing and marketing strategies. Although we may experience periodic effects on sales, gross profit and gross margins as a result of changing prices, we do not expect the effect of inflation or deflation to have a material impact on our ability to execute our long-term business strategy.

Seasonality

Our business is subject to modest seasonality. Our average weekly sales fluctuate throughout the year and are typically highest in the first half of the fiscal year. Produce, which contributed approximately 25% of our net sales for the thirteen weeks ended October 2, 2016, is generally more available in the first six months of our fiscal year due to the timing of peak growing seasons.

Critical Accounting Estimates

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

There have been no substantial changes to these estimates or the policies related to them during the thirty-nine weeks ended October 2, 2016. For a full discussion of these estimates and policies, see “Critical Accounting Estimates” in Item 7 of our Annual Report on Form 10-K for the fiscal year ended January 3, 2016.

Recently Issued Accounting Pronouncements

See Note 2 “Recently Issued Accounting Pronouncements” to our accompanying unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q.

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As described in Note 6, “Long-Term Debt” to our unaudited consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q, we have a Credit Facility that bears interest at a rate based in part on LIBOR. Accordingly, we are exposed to fluctuations in interest rates. Based on the \$205.0 million principal outstanding under our Credit Facility as of October 2, 2016, each hundred basis point change in LIBOR would result in a change in

interest expense by \$2.1 million annually.

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

28

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures under the Exchange Act as of October 2, 2016, the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective.

Changes in Internal Control Over Financial Reporting

During the quarterly period ended October 2, 2016, there were no changes in our internal controls over financial reporting that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

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

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against the Company and certain of its directors and officers on behalf of a purported class of purchasers of shares of the Company's common stock in the Company's underwritten secondary public offering which closed on March 10, 2015 (the "March 2015 Offering"). The complaint purports to state claims under Sections 11, 12 and 15 of the Securities Act of 1933, as amended, based on an alleged failure by the Company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint seeks damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. On March 24, 2016, the Company removed the action to federal court in the District of Arizona. On April 18, 2016, the plaintiffs filed a motion to remand the case to state court, and that motion is currently under consideration. The Company intends to defend this case vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the case.

"Phishing" Scam Actions

In April 2016, four complaints were filed, two in the federal courts of California, one in the Superior Court of California and one in the federal court in the District of Colorado, each on behalf of a purported class of current and former Company team members whose personally identifiable information ("PII") was inadvertently disclosed to an unauthorized third party that perpetrated an email "phishing" scam against a Company team member. The complaints allege the Company failed to properly safeguard the PII in accordance with applicable law. The complaints seek damages on behalf of the purported class in unspecified amounts, attorneys' fees and litigation expenses. In June 2016, a motion was filed before the Judicial Panel on Multidistrict Litigation ("JPML") to transfer and consolidate all four of the cases to the federal court in the District of Arizona. The JPML granted the motion on October 6, 2016, and the cases remained stayed pending the court's scheduling of an initial case management conference. The Company intends to defend these cases vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the cases.

Item 1A. Risk Factors.

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

the value of our common stock to decline, which could cause you to lose all or part of your investment.

There have been no material changes to the Risk Factors described under “Part I – Item 1A. Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended January 3, 2016.

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

Issuer Purchases of Equity Securities

The following table provides information about our share repurchase activity during the thirteen weeks ended October 2, 2016.

30

Period (1)	Total number of shares purchased	Average price paid per share	Total number of shares as part of publicly announced plans or programs (2)	Approximate dollar
				value of shares that may yet be purchased under the plans or programs (2)
August 29, 2016 - October 2, 2016	3,189,818	\$ 19.93	3,189,818	\$ 186,428,090

(1) Periodic information is presented by reference to our fiscal periods during the third quarter of fiscal year 2016.

(2) On September 6, 2016, our board of directors authorized a \$250 million share repurchase program of our common stock. The shares may be purchased on a discretionary basis from time to time through December 31, 2017, subject to general business and market conditions and other investment opportunities, through open market purchases, privately negotiated transactions, or other means, including through Rule 10b5-1 trading plans.

Item 6. Exhibits.

Exhibit

Number	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C.

Section 1350 as
adopted
pursuant to
Section 906 of
the
Sarbanes-Oxley
Act of 2002

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

101.INS XBRL Instance
Document

101.SCH XBRL
Taxonomy
Extension
Schema
Document

101.CAL XBRL
Taxonomy
Extension
Calculation
Linkbase
Document

101.DEF XBRL
Taxonomy
Extension
Definition
Linkbase
Document

101.LAB XBRL
Taxonomy
Extension Label
Linkbase
Document

101.PRE XBRL
Taxonomy

Extension
Presentation
Linkbase
Document

SIGNATURES

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

SPROUTS FARMERS MARKET, INC.

Date: November 3, 2016 By: /s/ Bradley S. Lukow
Name: Bradley S. Lukow
Title: Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

Exhibit	
Number	Description
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS

XBRL Instance
Document

XBRL
Taxonomy
Extension
Schema
101.SCH Document

XBRL
Taxonomy
Extension
Calculation
Linkbase
101.CAL Document

XBRL
Taxonomy
Extension
Definition
Linkbase
101.DEF Document

XBRL
Taxonomy
Extension Label
Linkbase
101.LAB Document

XBRL
Taxonomy
Extension
Presentation
Linkbase
101.PRE Document