

Section 1: 10-Q (10-Q)

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 29, 2019

or

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

For the transition period from to

Commission File Number: 001-36029



Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

32-0331600

(I.R.S. Employer
Identification No.)

5455 East High Street, Suite 111

Phoenix, Arizona 85054

(Address of principal executive offices and zip code)

(480) 814-8016

(Registrant's telephone number, including area code)

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

Title of Each Class
Common Stock, \$0.001 par value

Trading Symbol(s)
SFM

Name of Each Exchange on Which Registered
NASDAQ Global Select Market

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
		Emerging growth company	<input type="checkbox"/>

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

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

As of October 28, 2019, the registrant had 118,138,870 shares of common stock, \$0.001 par value per share, outstanding.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 29, 2019

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Forward-Looking Statements

This Quarterly Report on Form 10-Q contains “forward-looking statements” that involve substantial risks and uncertainties. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (referred to as the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (referred to as the “Exchange Act”), including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, and plans and objectives of management. In some cases, you can identify forward-looking statements by terms such as “anticipate,” “believe,” “estimate,” “expect,” “intend,” “may,” “might,” “plan,” “project,” “will,” “would,” “should,” “could,” “can,” “predict,” “potential,” “continue,” “objective,” or the negative of these terms, and similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievement to be materially different from those expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled “Risk Factors” included in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K for the fiscal year ended December 30, 2018, 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)

	September 29, 2019	December 30, 2018
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 79,912	\$ 1,588
Accounts receivable, net	14,212	40,564
Inventories	285,715	264,366
Prepaid expenses and other current assets	32,111	27,323
Total current assets	411,950	333,841
Property and equipment, net of accumulated depreciation	742,235	766,429
Operating lease assets	1,045,144	—
Intangible assets, net of accumulated amortization	185,440	194,803
Goodwill	368,078	368,078
Other assets	12,020	12,463
Total assets	<u>\$ 2,764,867</u>	<u>\$ 1,675,614</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 184,893	\$ 120,266
Accrued liabilities	158,010	133,703
Accrued salaries and benefits	44,229	48,603
Current portion of capital and financing lease obligations	—	7,428
Current portion of operating lease liabilities	84,356	—
Current portion of finance lease liabilities	628	—
Total current liabilities	472,116	310,000
Long-term capital and financing lease obligations	—	119,642
Long-term operating lease liabilities	1,107,872	—
Long-term debt and finance lease liabilities	526,699	453,000
Other long-term liabilities	43,932	153,377
Deferred income tax liability	54,327	50,399
Total liabilities	<u>2,204,946</u>	<u>1,086,418</u>
Commitments and contingencies (Note 8)		
Stockholders' equity:		
Undesignated preferred stock; \$0.001 par value; 10,000,000 shares authorized, no shares issued and outstanding	—	—
Common stock, \$0.001 par value; 200,000,000 shares authorized, 118,138,870 shares issued and outstanding, September 29, 2019; 124,975,691 shares issued and outstanding, December 30, 2018	118	124
Additional paid-in capital	668,522	657,140
Accumulated other comprehensive income (loss)	(5,635)	1,134
Accumulated deficit	(103,084)	(69,202)
Total stockholders' equity	559,921	589,196
Total liabilities and stockholders' equity	<u>\$ 2,764,867</u>	<u>\$ 1,675,614</u>

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

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

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018 (1)	September 29, 2019	September 30, 2018 (1)
Net sales	\$ 1,440,222	\$ 1,329,109	\$ 4,269,844	\$ 3,937,998
Cost of sales	963,497	885,693	2,843,989	2,611,492
Gross profit	476,725	443,416	1,425,855	1,326,506
Selling, general and administrative expenses	404,285	362,584	1,162,226	1,051,771
Depreciation and amortization (exclusive of depreciation included in cost of sales)	30,764	27,593	89,788	80,079
Store closure and other costs	2,119	461	3,396	497
Income from operations	39,557	52,778	170,445	194,159
Interest expense, net	(5,557)	(7,411)	(15,997)	(20,015)
Other income	—	—	—	320
Income before income taxes	34,000	45,367	154,448	174,464
Income tax provision	(7,740)	(7,867)	(36,453)	(28,631)
Net income	<u>\$ 26,260</u>	<u>\$ 37,500</u>	<u>\$ 117,995</u>	<u>\$ 145,833</u>
Net income per share:				
Basic	\$ 0.22	\$ 0.30	\$ 0.98	\$ 1.13
Diluted	\$ 0.22	\$ 0.29	\$ 0.98	\$ 1.12
Weighted average shares outstanding:				
Basic	<u>118,029</u>	<u>126,855</u>	<u>119,846</u>	<u>129,572</u>
Diluted	<u>118,174</u>	<u>127,627</u>	<u>120,227</u>	<u>130,537</u>

- (1) Effective in the fourth quarter of fiscal year 2018, the Company made a voluntary change in accounting principle to change the classification of certain expenses on its consolidated statements of income. The change was applied retrospectively to all periods presented. See Note 2, "Summary of Significant Accounting Policies" for further information.

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)
(IN THOUSANDS)

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Net income	\$ 26,260	\$ 37,500	\$ 117,995	\$ 145,833
Other comprehensive income, net of tax				
Unrealized gain/(loss) on cash flow hedging activities, net of income tax of (\$365), \$299, (\$2,341), and \$1,851	(1,056)	865	(6,769)	5,351
Total other comprehensive income (loss)	<u>\$ (1,056)</u>	<u>865</u>	<u>\$ (6,769)</u>	<u>5,351</u>
Comprehensive income	<u>\$ 25,204</u>	<u>\$ 38,365</u>	<u>\$ 111,226</u>	<u>\$ 151,184</u>

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

For the thirteen and thirty-nine weeks ended September 29, 2019

	Shares	Common Stock	Additional Paid In Capital	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
Balances at June 30, 2019	118,022,271	\$ 118	\$665,454	\$ (129,344)	\$ (4,579)	\$ 531,649
Net income	—	—	—	26,260	—	26,260
Other comprehensive loss	—	—	—	—	(1,056)	(1,056)
Issuance of shares under stock plans	25,849	—	358	—	—	358
Repurchase and retirement of common stock	—	—	—	—	—	—
Share-based compensation	—	—	2,710	—	—	2,710
Balances at September 29, 2019	<u>118,048,120</u>	<u>\$ 118</u>	<u>\$668,522</u>	<u>\$ (103,084)</u>	<u>\$ (5,635)</u>	<u>559,921</u>
	Shares	Common Stock	Additional Paid In Capital	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at December 30, 2018	124,581,190	\$ 124	\$657,140	\$ (69,202)	\$ 1,134	\$ 589,196
Net income	—	—	—	117,995	—	117,995
Other comprehensive loss	—	—	—	—	(6,769)	(6,769)
Issuance of shares under stock plans	769,808	1	4,481	—	—	4,482
Repurchase and retirement of common stock	(7,302,878)	(7)	—	(163,303)	—	(163,310)
Share-based compensation	—	—	6,901	—	—	6,901
Impact of adoption of ASC 842 related to leases	—	—	—	11,426	—	11,426
Balances at September 29, 2019	<u>118,048,120</u>	<u>\$ 118</u>	<u>\$668,522</u>	<u>\$ (103,084)</u>	<u>\$ (5,635)</u>	<u>559,921</u>

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (continued)
(UNAUDITED)
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

For the thirteen and thirty-nine weeks ended September 30, 2018

	Shares	Common Stock	Additional Paid In Capital	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at July 1, 2018	127,156,251	\$ 126	\$636,445	\$ (39,101)	\$ 3,702	\$ 601,172
Net income		—	—	37,500	—	37,500
Other comprehensive income		—	—	—	865	865
Issuance of shares under stock plans	772,088	1	14,021	—	—	14,022
Repurchase and retirement of common stock	(719,004)	—	—	(15,307)	—	(15,307)
Share-based compensation	—	—	3,043	—	—	3,043
Balances at September 30, 2018	<u>127,209,335</u>	<u>\$ 127</u>	<u>\$653,509</u>	<u>\$ (16,908)</u>	<u>\$ 4,567</u>	<u>\$ 641,295</u>

	Shares	Common Stock	Additional Paid In Capital	(Accumulated Deficit) Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at December 31, 2017	132,450,092	\$ 132	\$620,788	\$ 30,558	\$ (784)	\$ 650,694
Net income	—	—	—	145,833	—	145,833
Other comprehensive income	—	—	—	—	5,351	5,351
Issuance of shares under stock plans	3,170,818	3	21,048	—	—	21,051
Repurchase and retirement of common stock	(8,411,575)	(8)	—	(193,299)	—	(193,307)
Share-based compensation	—	—	11,673	—	—	11,673
Balances at September 30, 2018	<u>127,209,335</u>	<u>\$ 127</u>	<u>\$653,509</u>	<u>\$ (16,908)</u>	<u>\$ 4,567</u>	<u>\$ 641,295</u>

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)
(IN THOUSANDS)

	Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018
Cash flows from operating activities		
Net income	\$ 117,995	\$ 145,833
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	91,546	81,959
Operating lease asset amortization	62,251	—
Store closure and other costs	850	—
Share-based compensation	6,901	11,673
Deferred income taxes	(245)	29,773
Other non-cash items	(2,873)	1,281
Changes in operating assets and liabilities:		
Accounts receivable	28,978	(10,299)
Inventories	(21,348)	(23,503)
Prepaid expenses and other current assets	(2,379)	(13,758)
Other assets	(762)	(3,945)
Accounts payable and other accrued liabilities	100,674	3,240
Accrued salaries and benefits	(4,054)	(2,130)
Operating lease liabilities	(52,209)	—
Other long-term liabilities	(2,013)	15,342
Cash flows from operating activities	<u>323,312</u>	<u>235,466</u>
Cash flows from investing activities		
Purchases of property and equipment	(146,480)	(148,432)
Cash flows used in investing activities	<u>(146,480)</u>	<u>(148,432)</u>
Cash flows from financing activities		
Proceeds from revolving credit facilities	187,405	180,000
Payments on revolving credit facilities	(125,405)	(93,000)
Payments on capital and financing lease obligations	—	(3,349)
Payments on finance lease liabilities	(536)	—
Payments of deferred financing costs	—	(2,131)
Cash from landlords related to capital and financing lease obligations	—	2,113
Repurchase of common stock	(163,310)	(193,307)
Proceeds from exercise of stock options	4,483	21,051
Other	(320)	(59)
Cash flows used in financing activities	<u>(97,683)</u>	<u>(88,682)</u>
Increase in cash, cash equivalents, and restricted cash	79,149	(1,648)
Cash, cash equivalents, and restricted cash at beginning of the period	2,248	19,479
Cash, cash equivalents, and restricted cash at the end of the period	<u>\$ 81,397</u>	<u>\$ 17,831</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	\$ 15,212	\$ 19,784
Cash paid for income taxes	32,115	15,177
Supplemental disclosure of non-cash investing and financing activities		
Property and equipment in accounts payable	\$ 18,396	\$ 15,435
Property acquired through capital and financing lease obligations (ASC 840)	n/a	8,911

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

The accompanying unaudited consolidated financial statements include the accounts of the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial statements and are in the form prescribed by the Securities and Exchange Commission in instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company's financial position, results of operations and cash flows for the periods indicated. All material intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for any other interim period or for a full fiscal year. The information included in these consolidated financial statements and notes thereto should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included herein and Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto for the fiscal year ended December 30, 2018 ("fiscal year 2018") included in the Company's Annual Report on Form 10-K, filed on February 21, 2019.

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

The Company reports its results of operations on a 52- or 53-week fiscal calendar ending on the Sunday closest to December 31. The fiscal year ending December 29, 2019 ("fiscal year 2019") and fiscal year 2018 are 52-week years. The Company reports its results of operations on a 13-week quarter, except for 53-week fiscal years.

Certain reclassifications of amounts reported in prior periods have been made to conform with the current period presentation.

All dollar amounts are in thousands, unless otherwise noted.

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

2. Summary of Significant Accounting Policies

Change in Accounting Principle

In the fourth quarter of fiscal year 2018, the Company made a voluntary change in its accounting policy for the classification of certain expenses. Historically, the Company has presented store occupancy costs and buying costs in cost of goods sold. Under the new policy, the Company is presenting these expenses within selling, general and administrative expenses (“SG&A”). In addition, the Company changed the classification of depreciation and amortization (exclusive of supply chain-related depreciation included in cost of sales) from direct store expenses (“DSE”) and SG&A to a separate financial statement line item and combined DSE and store pre-opening costs into SG&A. These reclassifications had no impact on sales, income from operations, net income or earnings per share. In addition, there was no cumulative effect to retained earnings, equity, or net assets.

The Company made this voluntary change in accounting policy in order to better reflect the direct costs of acquiring products and making them available to its customers in cost of sales. Store occupancy costs and buying costs, which are largely sales and marketing driven, are more appropriately reflected in SG&A. The new presentation of operating expenses now largely disaggregates cash from non-cash operating expenses, which the Company believes provides better information to its financial statement users. The Company believes these changes are preferable because they enhance the comparability of its financial statements with those of many of its industry peers and align with how the Company internally manages and reviews costs and margin. These changes in presentation have been retrospectively applied to all prior periods. Refer to the table below for the impact to the thirteen and thirty-nine weeks ended September 30, 2018, as currently presented:

	Thirteen weeks ended September 30, 2018		
	Change in		
	Unadjusted	Accounting Principle	As Adjusted
Cost of sales	\$ 946,742	\$ (61,049)	\$ 885,693
Gross profit	382,367	61,049	443,416
Direct store expenses	281,365	(281,365)	—
Selling, general and administrative expenses	43,944	318,640	362,584
Depreciation and amortization (exclusive of depreciation included in cost of sales)	—	27,593	27,593
Store pre-opening costs	3,819	(3,819)	—

	Thirty-nine weeks ended September 30, 2018		
	Change in		
	Unadjusted	Accounting Principle	As Adjusted
Cost of sales	\$ 2,788,167	\$ (176,675)	\$ 2,611,492
Gross profit	1,149,831	176,675	1,326,506
Direct store expenses	816,933	(816,933)	—
Selling, general and administrative expenses	128,828	922,943	1,051,771
Depreciation and amortization (exclusive of depreciation included in cost of sales)	—	80,079	80,079
Store pre-opening costs	9,414	(9,414)	—

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

Revenue Recognition

The Company does not have any material contract assets or receivables from contracts with customers, any revenue recognized in the current period from performance obligations satisfied in previous periods, or any remaining performance obligations as of September 29, 2019. The Company had a net gift card liability balance of \$7.5 million as of September 29, 2019 and \$14.6 million as of December 30, 2018. The Company recognized \$1.4 million and \$9.6 million in gift card revenue from this liability during the thirteen and thirty-nine weeks ended September 29, 2019, respectively.

Restricted Cash

Restricted cash relates to defined benefit plan forfeitures as well as health and welfare restricted funds of approximately \$1.5 million and \$0.7 million as of September 29, 2019 and December 30, 2018, respectively. These balances are included in prepaid expenses and other current assets in the consolidated balance sheets.

Recently Adopted Accounting Pronouncements

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 financing or operating lease.

The Company adopted the standard as of December 31, 2018, the first day of fiscal year 2019. The Company elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, permits companies not to reassess prior conclusions on lease identification, lease classification and initial direct costs. The Company did not elect the hindsight practical expedient.

The adoption of the standard resulted in the recognition of operating lease assets and liabilities of approximately \$1.0 billion and \$1.1 billion, respectively, as of December 31, 2018, including recognition of operating lease assets and liabilities for certain third-party operated distribution center locations. Included in the measurement of the new lease assets and liabilities is the reclassification of balances historically recorded as deferred rent and unfavorable and favorable leasehold interests. Additionally, the Company recognized a cumulative effect adjustment, which increased retained earnings by \$11.4 million, net of tax. This adjustment was driven by the derecognition of approximately \$114.0 million of lease obligations and \$102.6 million of net assets related to leases that had been classified as financing lease obligations under the former failed-sale leaseback guidance, and are now classified as operating leases as of the transition date.

This reclassification also resulted in the recognition of rent expense beginning December 31, 2018, which was previously reported as interest expense under the former failed sale-leaseback guidance. Lastly, the adoption of this standard resulted in a change in naming convention for leases classified historically as capital leases. These leases are now referred to as finance leases. The adoption of this standard did not have any impact on the Company's liquidity or cash flows.

Refer to Note 5, "Leases", for additional information related to the Company's updated lease accounting policy.

Recently Issued Accounting Pronouncements Not Yet Adopted

In January 2017, the FASB issued ASU No. 2017-04, "Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." The amendments in this update eliminate the second step of the goodwill impairment test and provide that an entity will apply a one-step quantitative test and record the amount of goodwill impairment as the excess of a reporting unit's carrying amount over its fair value, not to exceed the total amount of goodwill allocated to the reporting unit. The new guidance does not amend the optional qualitative assessment of goodwill impairment. The guidance will be effective for the Company for its fiscal year 2020, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's consolidated financial statements.

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

In August 2018, the FASB issued ASU No. 2018-14, "Compensation — Retirement Benefits — Defined Benefit Plans — General (Subtopic 715-20) — Disclosure Framework — Changes to the Disclosure Requirements for Defined Benefit Plans." The amendments in this update remove disclosures that no longer are considered cost-beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. The guidance will be effective for the Company for its fiscal year 2020, with early adoption permitted. The Company does not expect this ASU to materially impact the Company's disclosures.

No other new accounting pronouncements issued or effective during the thirteen weeks ended September 29, 2019 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 valuation of derivative instruments, impairment analysis of goodwill, intangible assets and long-lived assets.

The following tables present the fair value hierarchy for the Company's financial assets and liabilities measured at fair value on a recurring basis as of September 29, 2019 and December 30, 2018:

September 29, 2019	Level 1	Level 2	Level 3	Total
Long-term debt	\$ —	\$ 515,000	\$ —	\$ 515,000
Interest rate swap liability	—	7,585	—	7,585
Total liabilities	\$ —	\$ 522,585	\$ —	\$ 522,585
Interest rate swap asset	\$ —	\$ —	\$ —	\$ —
Total assets	\$ —	\$ —	\$ —	\$ —
December 30, 2018	Level 1	Level 2	Level 3	Total
Long-term debt	\$ —	\$ 453,000	\$ —	\$ 453,000
Total liabilities	\$ —	\$ 453,000	\$ —	\$ 453,000
Interest rate swap asset	\$ —	\$ 1,522	\$ —	\$ 1,522
Total assets	\$ —	\$ 1,522	\$ —	\$ 1,522

The Company's interest rate swaps are considered Level 2 in the hierarchy and are valued using an income approach. Expected future cash flows are converted to a present value amount based on market expectations of the yield curve on floating interest rates, which is readily available on public markets.

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The determination of fair values of certain tangible and intangible assets for purposes of the Company's goodwill impairment evaluation as described above is based upon Level 3 inputs. The weighted average cost of capital is estimated using information from comparable companies and management's judgment related to the risk associated with the operations of the stores.

Cash, cash equivalents, restricted cash, accounts receivable, prepaid expenses and other current assets, accounts payable, accrued liabilities, and accrued salaries and benefits approximate fair value because of the short maturity of those instruments. Based on comparable open market transactions, the fair value of the long-term debt approximated carrying value as of September 29, 2019 and December 30, 2018.

4. Long-Term Debt and Finance Lease Liabilities

A summary of long-term debt and finance lease liabilities is as follows:

Facility	Maturity	Interest Rate	As of	
			September 29, 2019	December 30, 2018
Senior secured debt				
\$700.0 million Credit Agreement	March 27, 2023	Variable	\$ 515,000	\$ 453,000
Finance lease liabilities (see Note 5)	Various	n/a	11,699	—
Long-term debt and finance lease liabilities			<u>\$ 526,699</u>	<u>\$ 453,000</u>

Senior Secured Revolving Credit Facility

March 2018 Refinancing

On March 27, 2018, the Company's subsidiary, Sprouts Farmers Markets Holdings, LLC ("Intermediate Holdings"), as borrower, entered into an amended and restated credit agreement (the "Amended and Restated Credit Agreement") to amend and restate the Company's existing senior secured credit facility, dated April 17, 2015 (the "Former Credit Facility"). The Amended and Restated Credit Agreement provides for a revolving credit facility with an initial aggregate commitment of \$700.0 million, an increase from \$450.0 million from the Former Credit Facility, which may be increased from time to time pursuant to an expansion feature set forth in the Amended and Restated Credit Agreement.

Concurrently with the closing of the Amended and Restated Credit Agreement, all commitments under the Former Credit Facility were terminated, resulting in a \$0.3 million loss on early extinguishment of debt, recorded in interest expense during the first quarter of fiscal year 2018. The loss was due to the write-off of a proportional amount of deferred financing costs associated with the Former Credit Facility as the result of certain banks exiting the Amended and Restated Credit Agreement in connection with the refinancing. No amounts were outstanding under the Former Credit Facility as of September 29, 2019.

The Company capitalized debt issuance costs of \$2.1 million related to the refinancing which combined with the remaining \$0.7 million debt issuance costs for the Former Credit Facility, are being amortized on a straight-line basis to interest expense over the five-year term of the Amended and Restated Credit Agreement.

The Amended and Restated Credit Agreement also provides for a letter of credit sub-facility and a \$15.0 million swingline facility. Letters of credit issued under the Amended and Restated Credit Agreement reduce its borrowing capacity. Letters of credit totaling \$26.9 million have been issued as of September 29, 2019, primarily to support the Company's insurance programs.

On March 6, 2019, Intermediate Holdings entered into an amendment to the Amended and Restated Credit Agreement intended to align the treatment of certain lease accounting terms with the Company's adoption of ASC 842. This amendment had no impact on borrowing capacity, interest rate, or maturity.

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Guarantees

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

Interest and Fees

Loans under the Amended and Restated Credit Agreement initially bear interest at LIBOR plus 1.50% per annum or prime plus 0.5%. The interest rate margins are subject to adjustment pursuant to a pricing grid based on the Company's total net leverage ratio, as set forth in the Amended and Restated Credit Agreement. Under the terms of the Amended and Restated Credit Agreement, the Company is obligated to pay a commitment fee on the available unused amount of the commitments between 0.15% to 0.30% per annum, also pursuant to a pricing grid based on the Company's total net leverage ratio.

The interest rate on approximately 49% of outstanding debt under the Amended and Restated Credit Agreement is fixed, reflecting the effects of floating to fixed interest rate swaps (see Note 11, "Derivative Financial Instruments").

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

Payments and Borrowings

The Amended and Restated Credit Agreement is scheduled to mature, and the commitments thereunder will terminate on March 27, 2023, subject to extensions as set forth therein.

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

During the thirteen and thirty-nine weeks ended September 29, 2019 the Company borrowed an additional \$64.5 million and \$187.4 million, respectively, primarily for share repurchases. During the same periods, the Company made principal payments totaling \$64.5 million and \$125.4 million, respectively; resulting in total outstanding debt under the Amended and Restated Credit Agreement of \$515.0 million as of September 29, 2019. During fiscal year 2018, the Company borrowed \$233.0 million to be used in connection with the Company's share repurchase programs (see Note 9, "Stockholders' Equity") and made a total of \$128.0 million of principal payments; resulting in total outstanding debt under the Amended and Restated Credit Agreement of \$453.0 million at December 30, 2018.

Covenants

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

- incur additional indebtedness;
- grant additional liens;
- enter into sale-leaseback transactions;
- make loans or investments;
- merge, consolidate or enter into acquisitions;
- pay dividends or distributions;
- enter into transactions with affiliates;

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- enter into new lines of business;
- modify the terms of debt or other material agreements; and
- change its fiscal year.

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

In addition, the Amended and Restated Credit Agreement requires that the Company and its subsidiaries maintain a maximum total net leverage ratio not to exceed 3.25 to 1.00 and minimum interest coverage ratio not to be less than 1.75 to 1.00. Each of these covenants is tested on the last day of each fiscal quarter.

The Company was in compliance with all applicable covenants under the Amended and Restated Credit Agreement as of September 29, 2019.

Former Credit Facility

On April 17, 2015, Intermediate Holdings, as borrower, entered into the Former Credit Facility that provided for a revolving credit facility with an initial aggregate commitment of \$450.0 million, subject to an expansion feature set forth therein. The Former Credit Facility also provided for a letter of credit sub-facility and a \$15.0 million swingline facility.

The Former Credit Facility was scheduled to mature, and the commitments thereunder were scheduled to terminate, on April 17, 2020.

Loans under the Former Credit Facility bore interest, at the Company's option, either at adjusted LIBOR plus 1.50% per annum, or a base rate plus 0.50% per annum. The interest rate margins were subject to adjustment pursuant to a pricing grid based on the Company's total gross leverage ratio, as defined in the Former Credit Facility. Under the terms of the Former Credit Facility, the Company was obligated to pay a commitment fee on the available unused amount of the commitments equal to 0.20% per annum.

5. Leases

The Company leases all stores, distribution centers, and administrative offices. The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease assets, current portion of operating lease liabilities and noncurrent portion of operating lease liabilities in the Company's fiscal year 2019 consolidated balance sheet. Finance leases are included in property, plant, equipment, net, current portion of finance lease liabilities, and long-term debt and finance lease liabilities in the Company's fiscal year 2019 consolidated balance sheet. Operating lease payments are charged on a straight-line basis to rent expense, a component of selling, general and administrative expenses, over the lease term and finance lease payments are charged to interest expense and depreciation and amortization expense using a debt model over the lease term.

The Company's lease assets represent a right to use an underlying asset for the lease term and lease liabilities represent the Company's obligation to make lease payments arising from the lease. Lease assets and liabilities and the related rent expense are recognized at the lease commencement date (date on which the Company gains access to the property) based on the estimated present value of lease payments over the lease term, net of landlord allowances to be received. The Company accounts for the lease and non-lease components as a single lease component for all current classes of leases.

Most of the Company's lease agreements include variable payments related to pass-through costs for maintenance, taxes, and insurance. Additionally, some of the Company's lease agreements include rental payments based on a percentage of retail sales over contractual levels. These variable payments are not included in the measurement of the lease liability or asset and are expensed as incurred.

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As most of the Company's lease agreements do not provide an implicit rate, the Company uses an estimated incremental borrowing rate, which is derived from third-party information available at the lease commencement date, in determining the present value of lease payments. The rate used is for a secured borrowing of a similar term as the lease.

Most leases include one or more options to renew, with renewal terms that can extend the lease term from one to twenty years or more. The exercise of lease renewal options is at the Company's sole discretion. The lease term includes the initial contractual term as well as any options to extend the lease when it is reasonably certain that the Company will exercise that option. Leases with a term of 12 months or less ("short-term leases") are not recorded on the balance sheet. The Company does not currently have any material short-term leases. Additionally, the Company's lease agreements do not contain any residual value guarantees or material restrictive covenants.

The Company subleases certain real estate to third parties, which have all been classified as operating leases. The Company recognized sublease income on a straight-line basis.

ASC 842 Disclosures

Lease cost includes both the fixed and variable expenses recorded for leases. The components of lease cost for the thirty-nine weeks ended September 29, 2019 were as follows:

	Classification	Thirty-nine weeks ended September 29, 2019
Operating lease cost	Selling, general and administrative expenses (1)	\$ 131,092
Finance lease cost:		
Amortization of Property and Equipment	Depreciation and amortization	726
Interest on lease liabilities	Interest expense	753
Variable lease cost	Selling, general and administrative expenses (1)	39,368
Sublease income	Selling, general and administrative expenses	(767)
Total net lease cost		<u>\$ 171,172</u>

(1) Supply chain-related amounts of \$6.7 million of total net lease cost are included in cost of sales.

Supplemental balance sheet information related to leases was as follows:

	Classification	As of September 29, 2019
Assets		
Operating	Operating lease assets	\$ 1,045,144
Finance	Property and equipment, net	10,426
Total lease assets		<u>\$ 1,055,570</u>
Liabilities		
Current		
Operating	Current portion of operating lease liabilities	\$ 84,356
Finance	Current portion of finance lease liabilities	628
Noncurrent		
Operating	Long-term operating lease liabilities	1,107,872
Finance	Long-term debt and finance lease liabilities	11,699
Total lease liabilities		<u>\$ 1,204,555</u>

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	As of September 29, 2019
Weighted average remaining lease term (years)	
Operating leases	10.3
Finance leases	10.5
Weighted average discount rate	
Operating leases	7.4%
Finance leases	8.3%

Supplemental cash flow and other information related to leases was as follows:

	Thirty-nine weeks ended September 29, 2019
Cash paid for amounts included in measurement of lease liabilities:	
Operating cash flows for operating leases	\$ 114,971
Operating cash flows for finance leases	753
Lease assets obtained in exchange for lease liabilities:	
Finance leases	—
Operating leases	157,134

Maturities of lease liabilities:

	Operating Leases (1)	Finance Leases	Total
2019	\$ 32,612	\$ 398	\$ 33,010
2020	205,451	1,724	207,175
2021	188,986	1,591	190,577
2022	179,652	1,671	181,323
2023	157,529	1,556	159,085
2024	158,437	1,734	160,171
Thereafter	807,302	10,466	817,768
Total lease payments	1,729,969	19,140	1,749,109
Less: Imputed interest	(537,741)	(6,813)	(544,554)
Total lease liabilities	1,192,228	12,327	1,204,555
Less: Current portion	(84,356)	(628)	(84,984)
Long-term lease liabilities	\$ 1,107,872	\$ 11,699	\$ 1,119,571

- (1) Operating lease payment include \$105.8 million related to options to extend lease terms that are reasonably certain of being exercised and exclude \$254.7 million of legally binding minimum lease payments for leases executed but not yet commenced.

ASC 840 Disclosures related to periods prior to adoption of ASC 842:

Operating Lease Commitments

The Company's leases include stores, office and distribution centers. These leases had an average remaining lease term of approximately nine years as of December 30, 2018.

Rent expense in fiscal years 2018, 2017 and 2016 totaled \$137.5 million, \$120.5 million and \$104.8 million, respectively.

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Future minimum lease obligations for operating leases with initial terms in excess of one year at December 30, 2018 are as follows:

2019	\$	167,595
2020		179,058
2021		178,722
2022		170,515
2023		155,173
Thereafter		893,274
Total payments	\$	<u>1,744,337</u>

The Company has subtenant agreements under which it will receive rent as follows:

2019	\$	1,544
2020		1,623
2021		1,384
2022		1,290
2023		1,190
Thereafter		3,158
Total subtenant rent	\$	<u>10,189</u>

Capital and Financing Lease Commitments

The Company is committed under certain capital and financing leases for rental of buildings and equipment. These leases expire or become subject to renewal clauses at various dates from 2019 to 2034.

As of December 30, 2018, future minimum lease payments required by all capital and financing leases during the initial lease term are as follows:

Fiscal Year	Capital Leases	Financing Leases
2019	\$ 1,692	\$ 14,881
2020	1,591	14,865
2021	1,591	14,202
2022	1,662	12,538
2023	1,697	10,944
Thereafter	12,202	35,269
Total	20,435	102,699
Plus balloon payment (financing leases)	—	93,629
Less amount representing interest	(7,655)	(84,227)
Net present value of capital and financing lease obligations	12,780	112,101
Less current portion	(683)	(4,556)
Total long-term	<u>\$ 12,097</u>	<u>\$ 107,545</u>

The table above does not include \$2.2 million of current financing lease obligations expected to pass sale-leaseback accounting during 2019. The final payment under the financing lease obligations is a non-cash payment which represents the conveyance of the property to the buyer-lessor at the end of the lease term, described as balloon payment in the table above.

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6. Income Taxes

The Company's effective tax rate increased to 22.8% for the thirteen weeks ended September 29, 2019 compared to 17.3% for the thirteen weeks ended September 30, 2018. The lower effective tax rate for the period ended on September 30, 2018, was driven primarily from the tax impact of exercises of expiring pre-IPO options. The income tax effect resulting from excess tax benefits/ (detriments) of share-based payment awards were \$(0.3) million and \$1.0 million for the thirteen weeks ended September 29, 2019 and September 30, 2018, respectively.

The Company's effective tax rate increased to 23.6% for the thirty-nine weeks ended September 29, 2019 compared to 16.4% for the thirty-nine weeks ended September 30, 2018. The lower effective tax rate for the period ended on September 30, 2018, was driven primarily from the tax impact of exercises of expiring pre-IPO options. The income tax benefits resulting from excess tax benefits of share-based payment awards were \$0.1 million and \$12.4 million for the thirty-nine weeks ended September 29, 2019 and September 30, 2018, respectively.

The Company files income tax returns for federal purposes and in many states. The Company's tax filings remain subject to examination by applicable tax authorities for a certain length of time, generally three years, following the tax year to which those filings relate. The Company's U.S. federal income tax return for the fiscal year ended December 31, 2017 is currently under examination by the Internal Revenue Service.

7. Related-Party Transactions

A former member of the Company's board of directors was an investor in a company that was a supplier of coffee to the Company for resale. During the thirteen and thirty-nine weeks ended September 29, 2019, there were no purchases from this supplier. During the thirteen and thirty-nine weeks ended September 30, 2018, there were no purchases from this supplier and \$2.6 million of purchases, respectively. As of September 29, 2019, and December 30, 2018, there were no balances in accounts payable to this vendor. Effective January 1, 2019, this director no longer held an ownership interest in the supplier, and effective June 20, 2019, this director resigned from the Company's board of directors.

8. Commitments and Contingencies

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

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against the Company and certain of its directors and officers on behalf of a purported class of purchasers of shares of the Company's common stock in the Company's underwritten secondary public offering which closed on March 10, 2015 (the "March 2015 Offering"). The complaint purported 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 sought damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. On August 4, 2018, the Company reached an agreement in principle to settle these claims. The parties' settlement agreement was approved by the court on May 31, 2019 and the complaint was subsequently dismissed. The settlement was funded from the Company's directors and officers liability insurance policy and did not have a material impact on the Company's consolidated financial statements.

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9. Stockholders' Equity

Share Repurchases

The following table outlines the common stock share repurchase programs authorized by the Company's board of directors and the related repurchase activity and available authorization as of September 29, 2019.

Effective date	Expiration date	Amount authorized	Cost of repurchases	Authorization available
November 4, 2015	November 4, 2017	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	\$ 250,000	\$ 250,000	\$ —
February 20, 2017	December 31, 2018	\$ 250,000	\$ 250,000	\$ —
February 20, 2018	December 31, 2019	\$ 350,000	\$ 295,017	\$ 54,983

The shares under the Company's repurchase programs may be purchased on a discretionary basis from time to time prior to the applicable expiration date, subject to general business and market conditions and other investment opportunities, through open market purchases, privately negotiated transactions, or other means, including through Rule 10b5-1 trading plans. The board's authorization of the share repurchase programs does not obligate the Company to acquire any particular amount of common stock, and the repurchase programs may be commenced, suspended, or discontinued at any time. The Company has used borrowings under its Former Credit Facility and Amended and Restated Credit Agreement to assist with the repurchase programs (see Note 4, "Long-Term Debt and Finance Lease Liabilities").

Share repurchase activity under the Company's repurchase programs for the periods indicated was as follows (total cost in thousands):

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Number of common shares acquired	—	719,004	7,302,878	8,411,575
Average price per common share acquired	\$ —	\$ 21.29	\$ 22.36	\$ 22.98
Total cost of common shares acquired	\$ —	\$ 15,307	\$ 163,310	\$ 193,307

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

10. Net Income Per Share

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

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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	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Basic net income per share:				
Net income	\$ 26,260	\$ 37,500	\$ 117,995	\$ 145,833
Weighted average shares outstanding	118,029	126,855	119,846	129,572
Basic net income per share	\$ 0.22	\$ 0.30	\$ 0.98	\$ 1.13
Diluted net income per share:				
Net income	\$ 26,260	\$ 37,500	\$ 117,995	\$ 145,833
Weighted average shares outstanding - basic	118,029	126,855	119,846	129,572
Dilutive effect of share-based awards:				
Assumed exercise of options to purchase shares	32	341	62	484
RSUs	42	175	167	193
RSAs	25	82	58	137
PSAs	46	174	94	151
Weighted average shares and equivalent shares outstanding	118,174	127,627	120,227	130,537
Diluted net income per share	\$ 0.22	\$ 0.29	\$ 0.98	\$ 1.12

For the thirteen weeks ended September 29, 2019, the computation of diluted net income per share does not include 0.6 million options, 0.4 million RSUs and 0.1 million PSAs as those awards would have been antidilutive or were performance awards with performance conditions not yet deemed met. For the thirteen weeks ended September 30, 2018, the computation of diluted net income per share does not include 0.7 million options and 0.1 million PSAs as those awards would have been antidilutive.

For the thirty-nine weeks ended September 29, 2019, the computation of diluted net income per share does not include 0.6 million options, 0.3 million RSUs and 0.4 million PSAs as those awards would have been antidilutive or were performance awards with performance conditions not yet deemed met. For the thirty-nine weeks ended September 30, 2018, the computation of diluted net income per share does not include 1.1 million options and 0.1 million PSAs as those awards would have been antidilutive or were performance awards with performance conditions not yet deemed met.

11. Derivative Financial Instruments

The Company entered into an interest rate swap agreement in December 2017 to manage its cash flow associated with variable interest rates. This forward contract has been designated and qualifies as a cash flow hedge, and its change in fair value is recorded as a component of other comprehensive income and reclassified into earnings in the same period or periods in which the forecasted transaction occurs. The forward contract consists of four cash flow hedges. To qualify as a hedge, the Company needs to formally document, designate and assess the effectiveness of the transactions that receive hedge accounting.

The notional dollar amount of the four outstanding swaps was \$250.0 million at September 29, 2019 and December 30, 2018, under which the Company pays a fixed rate and receives a variable rate of interest (cash flow swap). The cash flow swaps hedge the change in interest rates on debt related to fluctuations in interest rates and each have a length of one year and mature annually from 2019 to 2022. These interest rate swaps have been designated and qualify as cash flow hedges and have met the requirements to assume zero ineffectiveness. The Company reviews the effectiveness of its hedging instruments on a quarterly basis.

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The counterparties to these derivative financial instruments are major financial institutions. The Company evaluates the credit ratings of the financial institutions and believes that credit risk is at an acceptable level. The following table summarizes the fair value of the Company's derivative instruments designated as hedging instruments:

	As of September 29, 2019		As of December 30, 2018	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate swaps	Other current assets	\$ —	Other current assets	\$ 944
Interest rate swaps	Accrued liabilities	143	Other assets	578
Interest rate swaps	Other long-term liabilities	7,442	Other long-term liabilities	—

The gain or loss on these derivative instruments is recognized in other comprehensive income, net of tax, with the portion related to current period interest payments reclassified to interest expense on the consolidated statements of income. The following table summarizes these gains and losses classified on the consolidated statements of income:

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Consolidated Statements of Income Classification				
Interest expense (income), net	\$ (54)	\$ (176)	\$ (458)	\$ (115)

12. Comprehensive Income

The following table presents the changes in accumulated other comprehensive income for the thirty-nine weeks ended September 29, 2019 and September 30, 2018.

	Cash Flow Hedges
Balance at December 31, 2017	\$ (784)
Other comprehensive income (loss), net of tax	
Unrealized gain on cash flow hedging activities, net of income tax of \$1,851	5,351
Total other comprehensive income	5,351
Balance at September 30, 2018	<u>\$ 4,567</u>
Balance at December 30, 2018	\$ 1,134
Other comprehensive income, net of tax	
Unrealized loss on cash flow hedging activities, net of income tax of (\$2,341)	(6,769)
Total other comprehensive income (loss)	(6,769)
Balance at September 29, 2019	<u>\$ (5,635)</u>

Amounts reclassified from accumulated other comprehensive income (loss) are included within interest expense on the consolidated statements of income.

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13. Segments

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

In accordance with Accounting Standards Codification 606, "Revenue from Contracts with Customers," the following table represents a disaggregation of revenue for the thirteen and thirty-nine weeks ended September 29, 2019 and September 30, 2018.

	Thirteen weeks ended			
	September 29, 2019		September 30, 2018	
Perishables	\$ 844,553	58.6%	\$ 777,413	58.5%
Non-Perishables	595,669	41.4%	551,696	41.5%
Net Sales	<u>\$ 1,440,222</u>	<u>100.0%</u>	<u>\$ 1,329,109</u>	<u>100.0%</u>

	Thirty-nine weeks ended			
	September 29, 2019		September 30, 2018	
Perishables	\$ 2,479,091	58.1%	\$ 2,283,348	58.0%
Non-Perishables	1,790,753	41.9%	1,654,650	42.0%
Net Sales	<u>\$ 4,269,844</u>	<u>100.0%</u>	<u>\$ 3,937,998</u>	<u>100.0%</u>

The Company categorizes the varieties of products it sells as perishable and non-perishable. Perishable product categories include produce, meat, seafood, deli, bakery, floral and dairy and dairy alternatives. Non-perishable product categories include grocery, vitamins and supplements, bulk items, frozen foods, beer and wine, and natural health and body care.

14. Share-Based Compensation

2013 Incentive Plan

The Company's board of directors adopted, and its equity holders approved, the Sprouts Farmers Market, Inc. 2013 Incentive Plan (the "2013 Incentive Plan"). The 2013 Incentive Plan became effective July 31, 2013 in connection with the Company's initial public offering and replaced the 2011 Option Plan (as defined below) (except with respect to outstanding options under the 2011 Option Plan). The 2013 Incentive Plan serves as the umbrella plan for the Company's share-based and cash-based incentive compensation programs for its directors, officers and other team members. Awards granted under these plans include RSUs, PSAs, and RSAs. 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.

Awards Granted

During the thirty-nine weeks ended September 29, 2019, the Company granted the following share-based compensation awards under the 2013 Incentive Plan:

Grant Date	RSUs	PSAs	Options
March 2019	386,115	95,768	53,866
May 2019	45,682	2,999	-
June 2019	177,975	75,000	-
August 2019	12,313	-	-
Total	<u>622,085</u>	<u>173,767</u>	<u>53,866</u>
Weighted-average grant date fair value	\$ 21.62	\$ 21.16	\$ 7.63
Weighted-average exercise price	—	—	\$ 23.12

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

The aggregate number of shares of common stock that may be issued to team members and directors under the 2013 Incentive Plan may not exceed 10,089,072. Shares subject to awards granted under the 2013 Incentive Plan which are subsequently forfeited, expire unexercised or are otherwise not issued will not be treated as having been issued for purposes of the share limitation. As of September 29, 2019, there were 1,645,626 stock awards outstanding and 5,839,056 shares remaining available for issuance under the 2013 Incentive Plan

2011 Option Plan

In May 2011, the Company adopted the Sprouts Farmers Markets, LLC Option Plan (the "2011 Option Plan") to provide team members or directors of the Company with options to acquire shares of the Company. The Company had authorized 12,100,000 shares for issuance under the 2011 Option Plan. Options may no longer be issued under the 2011 Option Plan. As of September 29, 2019, there were 50,000 options outstanding under the 2011 Option Plan.

Stock Options

The Company uses the Black-Scholes option pricing model to estimate the fair value of options at grant date. Options vest in accordance with the terms set forth in the grant letter.

Time-based options granted prior to fiscal year 2016 generally vested ratably over a period of 12 quarters (three years), and time-based options granted after 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 fiscal year 2016 are restricted shares that were 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 performance conditions with respect to the EBIT targets were deemed to not have been met, and all relevant PSAs have forfeited.

PSAs granted in March 2017 were subject to the Company achieving certain earnings per share performance targets during fiscal year 2017. The criteria was based on a range of performance targets in which grantees could earn between 10% and 150% of the base number of awards granted. The performance conditions with respect to fiscal year 2017 earnings per share were deemed to have been met, and the PSAs vested 50% on the second anniversary of the grant date (March 2019) and will vest 50% on the third anniversary of the grant date (March 2020). During the thirty-nine weeks ended September 29, 2019, 106,360 of the 2017 PSAs were vested.

PSAs granted in March 2018 are subject to the Company achieving certain EBIT performance targets for the 2020 fiscal year. The criteria is based on a range of performance targets in which grantees may earn 0% to 200% of the base number of awards granted. If performance conditions are met, the applicable number of performance shares will vest on the third anniversary of the grant date (March 2021).

PSAs granted in 2019 are subject to the Company achieving certain EBIT performance targets for the 2021 fiscal year. The criteria is based on a range of performance targets in which grantees may earn 0% to 200% of the base number of awards granted. If performance conditions are met, the applicable number of performance shares will vest in March 2022.

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

RSAs

The fair value of RSAs is based on the closing price of the Company's common stock on the grant date. Outstanding RSA grants vest annually over three years.

Share-based Compensation Expense

The Company presents share-based compensation expense in selling, general and administrative expenses on the Company's consolidated statements of income. The amount recognized was as follows:

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Share-based compensation expense				
before income taxes	\$ 2,710	\$ 3,043	\$ 6,901	\$ 11,673
Income tax benefit	(697)	(782)	(1,647)	(3,000)
Net share-based compensation expense	<u>\$ 2,013</u>	<u>\$ 2,261</u>	<u>\$ 5,254</u>	<u>\$ 8,673</u>

The following share-based awards were outstanding as of September 29, 2019 and September 30, 2018:

	As of	
	September 29, 2019	September 30, 2018
	(in thousands)	
Options		
Vested	578	1,816
Unvested	64	98
RSUs	774	694
PSAs	225	366
RSAs	55	182

As of September 29, 2019, total unrecognized compensation expense and remaining weighted average recognition period related to outstanding share-based awards was as follows:

	Unrecognized compensation expense	Remaining weighted average recognition period
Options	\$ 389	2.4
RSUs	13,015	2.0
PSAs	3,042	1.9
RSAs	426	0.4
Total unrecognized compensation expense at September 29, 2019	<u>\$ 16,872</u>	

During the thirty-nine weeks ended September 29, 2019 and September 30, 2018, the Company received \$4.5 million and \$21.1 million, respectively, in cash proceeds from the exercise of options.

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

You should read the following discussion of our financial condition and results of operations together with the consolidated financial statements and related notes that are included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K filed for the 2018 fiscal year, February 21, 2019 with the Securities and Exchange Commission. All dollar amounts included below are in thousands, unless otherwise noted.

Business Overview

Sprouts Farmers Market operates healthy grocery stores that specialize in fresh, natural and organic products at prices that appeal to everyday grocery shoppers. Based on the belief that healthy food should be affordable, Sprouts’ welcoming environment and knowledgeable team members continue to drive its growth. Sprouts offers a complete shopping experience that includes an array of fresh produce in the heart of the store, a deli with prepared entrees and side dishes, The Butcher Shop, The Fish Market, an expansive vitamins and supplements department and more. Since our founding in 2002, we have grown rapidly, significantly increasing our sales, store count and profitability. With 335 stores in 21 states as of September 29, 2019, we are one of the largest specialty retailers of fresh, natural and organic food in the United States. As of October 30, 2019, we have grown to 339 stores in 22 states.

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

Our Heritage

In 2002, we opened the first Sprouts Farmers Market store in Chandler, Arizona. From our founding in 2002 through September 29, 2019, we have continued to open new stores while successfully rebranding 43 Henry’s Farmers Market and 39 Sunflower Farmers Market stores added in 2011 and 2012, respectively, through acquisitions to the Sprouts banner. These three businesses all trace their lineage back to Henry’s Farmers Market and were built with similar store formats and operations including a strong emphasis on value, produce and service in smaller, convenient locations. The consistency of these formats and operations was an important factor that allowed us to rapidly and successfully rebrand and integrate each of these businesses under the Sprouts banner and on a common platform.

Outlook

We are pursuing a number of strategies designed to continue our growth, including expansion of our store base, continuing positive comparable store sales and growing the Sprouts brand. We intend to continue expanding our store base by pursuing new store openings in our existing markets, expanding into adjacent markets and penetrating new markets. Although we plan to expand our store base primarily through new store openings, we may grow through strategic acquisitions if we identify suitable targets and are able to negotiate acceptable terms and conditions for acquisition. In the current year, we have opened 27 new stores through October 30, 2019.

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

Results of Operations for Thirteen Weeks Ended September 29, 2019 and September 30, 2018

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	
	September 29, 2019	September 30, 2018 (1)
Unaudited Quarterly Consolidated Statement of Income Data:		
Net sales	\$ 1,440,222	\$ 1,329,109
Cost of sales	963,497	885,693
Gross profit	476,725	443,416
Selling, general and administrative expenses	404,285	362,584
Depreciation and amortization (exclusive of depreciation included in cost of sales)	30,764	27,593
Store closure and other costs	2,119	461
Income from operations	39,557	52,778
Interest expense, net	(5,557)	(7,411)
Other income	—	—
Income before income taxes	34,000	45,367
Income tax provision	(7,740)	(7,867)
Net income	<u>\$ 26,260</u>	<u>\$ 37,500</u>
Weighted average shares outstanding	118,029	126,855
Diluted effect of equity-based awards	145	772
Weighted average shares and equivalent shares outstanding	118,174	127,627
Diluted net income per share	<u>\$ 0.22</u>	<u>\$ 0.29</u>

	Thirteen weeks ended	
	September 29, 2019	September 30, 2018
Other Operating Data:		
Comparable store sales growth	1.5%	1.5%
Stores at beginning of period	326	301
Closed	—	—
Opened	9	12
Stores at end of period	<u>335</u>	<u>313</u>

- (1) Effective in the fourth quarter of fiscal year 2018, we made a voluntary change in accounting principle to change the classification of certain expenses on our consolidated statements of income. The change was applied retrospectively to all periods presented. See Note 2, "Summary of Significant Accounting Policies" for further information.

Comparison of Thirteen Weeks Ended September 29, 2019 to Thirteen Weeks Ended September 30, 2018

Net sales

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Net sales	\$ 1,440,222	\$ 1,329,109	\$ 111,113	8%
Comparable store sales growth	1.5%	1.5%		

Net sales during the thirteen weeks ended September 29, 2019 totaled \$1.4 billion, an increase of \$111.1 million, or 8% compared to the thirteen weeks ended September 30, 2018. Sales growth was primarily driven by strong performance in new stores opened in the last twelve months and a 1.5% increase in comparable store sales. Comparable stores contributed approximately 91% of total sales for the thirteen weeks ended September 29, 2019 and approximately 90% for the thirteen weeks ended September 30, 2018.

Cost of sales and gross profit

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Net sales	\$ 1,440,222	\$ 1,329,109	\$ 111,113	8%
Cost of sales	963,497	885,693	77,804	9%
Gross profit	476,725	443,416	33,309	8%
Gross margin	33.1%	33.4%	(0.3)%	

Gross profit totaled \$476.7 million during the thirteen weeks ended September 29, 2019, an increase of \$33.3 million, or 8% compared to the thirteen weeks ended September 30, 2018, primarily driven by increased sales volume. Gross margin decreased by 0.3% to 33.1% compared to 33.4% for the thirteen weeks ended September 30, 2018, primarily driven by increased promotions and slightly higher distribution and transportation costs.

Selling, general and administrative expenses

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Selling, general and administrative expenses	\$ 404,285	\$ 362,584	\$ 41,701	12%
Percentage of net sales	28.1%	27.3%	0.8%	

Selling, general and administrative expenses increased \$41.7 million, or 12%, compared to the thirteen weeks ended September 30, 2018. The increase is primarily related to the new stores which have opened since the comparable period last year. As a percentage of net sales, selling, general and administrative expenses increased primarily due to higher occupancy costs related to the adoption of the new lease accounting standard that went into effect at the beginning of fiscal year 2019, increased costs associated with the expansion of our home delivery program, and higher healthcare costs.

Depreciation and amortization

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Depreciation and amortization	\$ 30,764	\$ 27,593	\$ 3,171	12%
Percentage of net sales	2.1%	2.1%	—	

Depreciation and amortization expenses (exclusive of depreciation included in cost of sales) increased \$3.2 million primarily related to new store growth as well as remodel initiatives in older stores.

Store closure and other costs

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Store closure and other costs	\$ 2,119	\$ 461	\$ 1,658	n/m
Percentage of net sales	n/m	n/m	n/m	

Store closure and other costs during the thirteen weeks ended September 29, 2019 primarily represents charges associated with executive severance and hurricane preparedness.

Interest expense

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Long-term debt	\$ 5,136	\$ 4,312	\$ 824	19%
Capital and financing leases	246	3,023	(2,777)	(92)%
Deferred financing costs	141	141	—	0%
Interest rate hedge and other	34	(65)	99	n/m
Total interest expense, net	<u>\$ 5,557</u>	<u>\$ 7,411</u>	<u>\$ (1,854)</u>	<u>(25)%</u>

The decrease in interest expense is due to the reclassification of previously reported financing leases to operating leases in connection with the adoption of the new lease accounting standard that went into effect at the beginning of 2019, partially offset by the higher average balance outstanding under the Amended and Restated Credit Agreement to fund our share repurchase program.

Income tax provision

Income tax provision differed from the amounts computed by applying the U.S. federal income tax rate to pretax income as a result of the following:

	Thirteen weeks ended	
	September 29, 2019	September 30, 2018
Federal statutory rate	21.0%	21.0%
Change in income taxes resulting from:		
State income taxes, net of federal benefit	4.8%	4.9%
Federal credits and charitable contributions	(11.2)%	(2.1)%
Other, net	8.2%	(6.5)%
Effective tax rate	<u>22.8%</u>	<u>17.3%</u>

The effective tax rate increased to 22.8% in the third quarter of 2019 from 17.3% in the comparable period last year. The lower tax rate in the prior period is primarily related to the exercising of pre-IPO options cycling in the current year.

Net income

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Net income	\$ 26,260	\$ 37,500	\$ (11,240)	(30)%
Percentage of net sales	1.8%	2.8%	(1.0)%	

Net income decreased \$11.2 million primarily due to higher selling, general and administration expense including the impact of occupancy costs related to the adoption of the new lease standard that went into effect at the beginning of 2019 combined with higher store closure and other costs.

Diluted earnings per share

	Thirteen weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Diluted earnings per share	\$ 0.22	\$ 0.29	\$ (0.07)	(24)%
Diluted weighted average shares outstanding	118,174	127,627	(9,453)	

The decrease in diluted earnings per share of \$0.07 was driven by lower net income, partially offset by fewer diluted shares outstanding compared to the prior year, due primarily to our share repurchase program.

Results of Operations for Thirty-nine Weeks Ended September 29, 2019 and September 30, 2018

The following tables set forth our unaudited results of operations and other operating data for the periods presented. As of December 31, 2018, we adopted the new lease standard. This adoption did not require us to recast prior periods; however, we recognized a cumulative effect adjustment, which increased retained earnings by \$11.4 million, net of tax. 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	
	September 29, 2019	September 30, 2018 (1)
Unaudited Quarterly Consolidated Statement of Income Data:		
Net sales	\$ 4,269,844	\$ 3,937,998
Cost of sales	<u>2,843,989</u>	<u>2,611,492</u>
Gross profit	1,425,855	1,326,506
Selling, general and administrative expenses	1,162,226	1,051,771
Depreciation and amortization (exclusive of depreciation included in cost of sales)	89,788	80,079
Store closure and other costs	<u>3,396</u>	<u>497</u>
Income from operations	170,445	194,159
Interest expense, net	(15,997)	(20,015)
Other income	—	320
Income before income taxes	154,448	174,464
Income tax provision	<u>(36,453)</u>	<u>(28,631)</u>
Net income	<u>\$ 117,995</u>	<u>\$ 145,833</u>
Net income per share:		
Basic	\$ 0.98	\$ 1.13
Diluted	\$ 0.98	\$ 1.12
Weighted average shares outstanding:		
Basic	<u>119,846</u>	<u>129,572</u>
Diluted	<u>120,227</u>	<u>130,537</u>

	Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018
Other Operating Data:		
Comparable store sales growth	1.0%	2.0%
Stores at beginning of period	313	285
Closed	(1)	—
Opened	<u>23</u>	<u>28</u>
Stores at end of period	<u>335</u>	<u>313</u>

- (1) Effective in the fourth quarter of fiscal year 2018, we made a voluntary change in accounting principle to change the classification of certain expenses on our consolidated statements of income. The change was applied retrospectively to all periods presented. See Note 2, "Summary of Significant Accounting Policies" for further information.

Comparison of Thirty-nine weeks ended September 29, 2019 to Thirty-nine weeks ended September 30, 2018

Net sales

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Net sales	\$ 4,269,844	\$ 3,937,998	\$ 331,846	8%
Comparable store sales growth	1.0%	2.0%		

Net sales during the thirty-nine weeks ended September 29, 2019 totaled \$4.3 billion, an increase of \$331.8 million, or 8%, compared to thirty-nine weeks ended September 30, 2018. Sales growth was primarily driven by strong performance in new stores opened in the last twelve months and a 1.0% increase in comparable store sales. Comparable stores contributed approximately 91% of total sales for the thirty-nine weeks ended September 29, 2019 and approximately 89% for the thirty-nine weeks ended September 30, 2018.

Cost of sales and gross profit

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Net sales	\$ 4,269,844	\$ 3,937,998	\$ 331,846	8%
Cost of sales, buying and occupancy	2,843,989	2,611,492	232,497	9%
Gross profit	1,425,856	1,326,506	99,350	7%
Gross margin	33.4%	33.7%	(0.3)%	

Gross profit totaled \$1.4 billion during the thirty-nine weeks ended September 29, 2019, an increase of \$99.4 million, or 7%, compared to the thirty-nine weeks ended September 30, 2018, primarily driven by increased sales volume. Gross margin decreased by 0.3% to 33.4% compared to 33.7% for the thirty-nine weeks ended September 30, 2018, primarily driven by increased promotions and slightly higher distribution and transportation costs.

Selling, general and administrative expenses

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Selling, general and administrative expenses	\$ 1,162,226	\$ 1,051,771	\$ 110,455	11%
Percentage of net sales	27.2%	26.7%	0.5%	

Selling, general and administrative expenses increased \$110.5 million, or 11%, compared to the thirty-nine weeks ended September 30, 2018. The increase is primarily related to the new stores which have opened since the comparable period last year. As a percentage of net sales, selling, general and administrative expenses increased primarily due to higher occupancy costs related to the adoption of the new lease standard that went into effect at the beginning of fiscal year 2019 and higher costs associated with the expansion of our home delivery program. These increased costs were partially offset by lower payroll taxes for California team members.

Depreciation and amortization

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Depreciation and amortization	\$ 89,788	\$ 80,079	\$ 9,709	12%
Percentage of net sales	2.1%	2.0%	0.1%	

Depreciation and amortization expenses (exclusive of depreciation included in cost of sales) increased \$9.7 million primarily related to new store growth as well as remodel initiatives in older vintages.

Store closure and other costs

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Store closure and other costs	\$ 3,396	\$ 497	\$ 2,899	n/m
Percentage of net sales	n/m	n/m	n/m	

Store closure and other costs during the thirty-nine weeks ended September 29, 2019 primarily represents charges associated with a planned store closure, relocation of another store upon expiration of the lease, and executive severance costs.

Interest expense

	Thirty-nine weeks ended		Change	% Change
	September 29, 2019	September 30, 2018		
Long-term debt	\$ 8,946	\$ 10,495	\$ (1,549)	(15)%
Capital and financing leases	753	8,748	(7,995)	(91)%
Deferred financing costs	423	658	(235)	(36)%
Interest rate hedge and other	5,875	114	5,761	n/m
Total Interest Expense	<u>\$ 15,997</u>	<u>\$ 20,015</u>	<u>\$ (4,018)</u>	<u>(20)%</u>

The decrease in interest expense is due to the reclassification of previously reported financing leases to operating leases in connection with the adoption of the new lease standard that went into effect at the beginning of 2019, partially offset by the higher average balance outstanding under the Amended and Restated Credit Agreement to fund our share repurchase program.

Income tax provision

Income tax provision differed from the amounts computed by applying the U.S. federal income tax rate to pretax income as a result of the following:

	Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018
Federal statutory rate	21.0%	21.0%
Decrease in income taxes resulting from:		
State income taxes, net of federal benefit	4.9%	4.9%
Federal credits and charitable contributions	(2.5)%	(7.1)%
Other, net	0.2%	(2.4)%
Effective tax rate	<u>23.6%</u>	<u>16.4%</u>

The effective tax rate increased to 23.6% for the thirty-nine weeks ended September 29, 2019 from 16.4% in the same period last year. This increase was primarily due to the prior year excess tax benefits for the exercise of expiring pre-IPO options in the first half of fiscal year 2018.

Net income

	<u>Thirty-nine weeks ended</u>		<u>Change</u>	<u>% Change</u>
	<u>September 29, 2019</u>	<u>September 30, 2018</u>		
Net income	\$ 117,995	\$ 145,833	\$ (27,838)	(19)%
Percentage of net sales	2.8%	3.7%	(0.9)%	

Net income decreased \$27.8 million primarily due to higher occupancy costs related to the adoption of the new lease standard that went into effect at the beginning of 2019, as well as cycling a lower effective tax rate in 2018.

Diluted earnings per share

	<u>Thirty-nine weeks ended</u>		<u>Change</u>	<u>% Change</u>
	<u>September 29, 2019</u>	<u>September 30, 2018</u>		
Diluted earnings per share	\$ 0.98	\$ 1.12	\$ (0.14)	(13)%
Diluted weighted average shares outstanding	120,227	130,537	(10,310)	

The decrease in diluted earnings per share of \$0.14 was driven by lower net income, partially offset by fewer diluted shares outstanding compared to the prior year, primarily due to our share repurchase program.

Return on Invested Capital

In addition to reporting financial results in accordance with generally accepted accounting principles, or GAAP, we provide information regarding Return on Invested Capital (referred to as "ROIC") as additional information about our operating results. ROIC is a non-GAAP financial measure and should not be reviewed in isolation or considered as a substitute for our financial results as reported in accordance with GAAP. ROIC is an important measure used by management to evaluate our investment returns on capital and provides a meaningful measure of the effectiveness of our capital allocation over time.

We define ROIC as net operating profit after tax (referred to as "NOPAT"), including the effect of capitalized operating leases, divided by average invested capital. Operating lease interest represents the add-back to operating income driven by the hypothetical interest expense we would incur if the property under our operating leases were owned or accounted for as a finance lease (capital lease prior to adoption of ASC 842). The assumed ownership and associated interest expense are calculated using the discount rate for each lease as recorded as a component of rent expense within selling, general and administrative expenses. Invested capital reflects a trailing twelve-month average.

As numerous methods exist for calculating ROIC, our method may differ from methods used by other companies to calculate their ROIC. It is important to understand the methods and the differences in those methods used by other companies to calculate their ROIC before comparing our ROIC to that of other companies.

Our calculation of ROIC for the fiscal periods indicated was as follows:

	Rolling Four Quarters Ended	
	September 29, 2019	September 30, 2018
	(dollars in thousands)	
Net Income (1)	\$ 130,698	\$ 185,531
Income Tax Adjustment for Tax Act (2)	—	(21,266)
Special items, net of tax (3)	11,950	—
Interest expense, net of tax (4)	17,829	20,534
Net operating profit after tax (NOPAT)	<u>\$ 160,477</u>	<u>\$ 184,799</u>
Total rent expense, net of tax (4)	123,259	104,958
Estimated depreciation on operating leases, net of tax (4)	(56,210)	(46,182)
Estimated interest on operating leases, net of tax (4) (5) (6)	67,049	58,776
NOPAT, including effect of operating leases	<u>\$ 227,526</u>	<u>\$ 243,575</u>
Average working capital	32,520	21,536
Average property and equipment	744,219	738,424
Average other assets	570,363	573,946
Average other liabilities	(145,847)	(192,287)
Average invested capital	<u>\$ 1,201,255</u>	<u>\$ 1,141,619</u>
Average operating leases (7)	1,192,228	1,053,271
Average invested capital, including operating leases	<u>\$ 2,393,483</u>	<u>\$ 2,194,890</u>
ROIC	<u>13.4%</u>	<u>16.2%</u>
ROIC, including operating leases	<u>9.5%</u>	<u>11.1%</u>

(1) Net income amounts represent total net income for past four trailing quarters.

(2) \$18.7 million income tax benefit related to the Tax Cuts and Job Act enacted in December 2017 and \$2.6 million income tax benefit related to tax calculation method changes recognized in the third quarter of 2018.

- (3) Special items include \$8.0 million (after-tax) related to store closures and \$4.0 million (after-tax) related to executive severance.
- (4) Net of tax amounts are calculated using the effective tax rate for the periods presented.
- (5) 2019 interest on operating leases represents the add back to operating income driven by hypothetical interest expense we would incur if the property under our operating leases were accounted for as financing leases. Estimated interest is calculated by multiplying operating leases by the 7.4 percent discount rate for each lease recorded as rent expense.
- (6) 2018 interest on operating leases is calculated as the trailing four quarters' rent expense multiplied by eight and by a 7.0 percent interest rate factor.
- (7) 2019 average operating leases represents the net present value of outstanding operating lease obligations. 2018 average operating leases is calculated as the trailing four quarters' rent expense multiplied by eight and by a 7.0 percent interest rate factor.

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

	Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018
Cash, cash equivalents and restricted cash at end of period	\$ 81,397	\$ 17,831
Cash flows from operating activities	\$ 323,312	\$ 235,466
Cash flows used in investing activities	\$ (146,480)	\$ (148,432)
Cash flows used in financing activities	\$ (97,683)	\$ (88,682)

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, cash equivalents and restricted cash, and cash anticipated to be generated from operations will be sufficient to meet our anticipated cash needs for at least the next 12 months, and we may continue to use borrowings under our Amended and Restated Credit Agreement as discussed in Note 4, "Long-Term Debt and Finance Lease Liabilities," primarily to fund our share repurchase programs. Our future capital requirements will depend on many factors, including new store openings, remodel and maintenance capital expenditures at existing stores, store initiatives and other corporate capital expenditures and activities. Our cash, cash equivalents and restricted cash 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 \$87.8 million to \$323.3 million for the thirty-nine weeks ended September 29, 2019 compared to \$235.5 million for the thirty-nine weeks ended September 30, 2018. The increase in cash flows from operating activities is primarily a result of changes in working capital.

Cash flows provided by/(used in) operating activities from changes in working capital was \$101.9 million in the thirty-nine weeks ended September 29, 2019 compared to (\$46.5) million in the thirty-nine weeks ended September 30, 2018, primarily driven by elevated accounts payable and accrual balances in the current period.

Investing Activities

Cash flows used in investing activities consist primarily of capital expenditures in new stores, including leasehold improvements and store equipment, capital expenditures to maintain the appearance of our stores, sales enhancing initiatives and other corporate investments. Cash flows used in investing activities were \$146.5 million and \$148.4 million, for the thirty-nine weeks ended September 29, 2019 and September 30, 2018, respectively.

We expect capital expenditures to be in the range of \$150 - \$160 million in fiscal year 2019, 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 Amended and Restated Credit Agreement.

Financing Activities

Cash flows used in financing activities were \$97.7 million for the thirty-nine weeks ended September 29, 2019 compared to \$88.7 million for the thirty-nine weeks ended September 30, 2018. During the thirty-nine weeks ended September 29, 2019, cash flows used in financing activities primarily consisted of \$163.3 million for stock repurchases, partially offset by \$62.0 million of net borrowings on our credit facilities, and \$4.5 million in proceeds from the exercise of stock options.

During the thirty-nine weeks ended September 30, 2018, cash flows used in financing activities primarily consisted of \$193.3 million for stock repurchases, partially offset by \$87.0 million of net borrowings on our credit facilities, and \$21.1 million in proceeds from the exercise of stock options.

Long-Term Debt and Credit Facilities

Long-term debt increased \$62.0 million to \$515.0 million as of September 29, 2019, compared to December 30, 2018. The increase resulted primarily from net borrowings under our Amended and Restated Credit Agreement used to fund our share repurchase programs.

See Note 4, "Long-Term Debt and Finance Lease Liabilities" of our unaudited consolidated financial statements for a description of our Amended and Restated Credit Agreement and our Former Credit Facility (each as defined therein).

Share Repurchase Program

Our board of directors from time to time authorizes share repurchase programs for our common stock. The following table outlines the share repurchase programs authorized by our board, and the related repurchase activity and available authorization as of September 29, 2019.

<u>Effective date</u>	<u>Expiration date</u>	<u>Amount authorized</u>	<u>Cost of repurchases</u>	<u>Authorization available</u>
November 4, 2015	November 4, 2017	\$ 150,000	\$ 150,000	\$ —
September 6, 2016	December 31, 2017	\$ 250,000	\$ 250,000	\$ —
February 20, 2017	December 31, 2018	\$ 250,000	\$ 250,000	\$ —
February 20, 2018	December 31, 2019	\$ 350,000	\$ 295,017	\$ 54,983

The shares under our 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. Our board's authorization of the share repurchase programs does not obligate our company to acquire any particular amount of common stock, and the repurchase programs may be commenced, suspended, or discontinued at any time. We have used borrowings under our Former Credit Facility and Amended and Restated Credit Agreement to assist with the repurchase programs. See Note 4, "Long-Term Debt and Finance Lease Liabilities" of our unaudited consolidated financial statements, for more details.

Share repurchase activity under our repurchase programs for the periods indicated was as follows (total cost in thousands):

	Thirteen weeks ended		Thirty-nine weeks ended	
	September 29, 2019	September 30, 2018	September 29, 2019	September 30, 2018
Number of common shares acquired	—	719,004	7,302,878	8,411,575
Average price per common share acquired	\$ —	\$ 21.29	\$ 22.36	\$ 22.98
Total cost of common shares acquired	\$ —	\$ 15,307	\$ 163,310	\$ 193,307

Shares purchased under our repurchase programs were subsequently retired.

Contractual Obligations

We are committed under certain operating and finance leases for the rental of land, buildings, and for rental of facilities and equipment. These leases expire or become subject to renewal clauses at various dates through 2036.

The following table summarizes our contractual obligations as of September 29, 2019, 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	3-5 Years	More Than 5 Years
	(in thousands)				
\$700.0 million Credit Agreement (1)	515,000	\$ —	\$ —	\$ 515,000	\$ —
Interest payments on \$700.0 million Credit Agreement (2)	72,449	6,258	40,663	25,528	—
Finance lease obligations (3)	19,139	1,591	3,227	3,416	10,905
Operating lease obligations (3)	1,900,671	193,328	397,805	352,944	956,594
Totals	\$ 2,507,259	\$ 201,177	\$ 441,695	\$ 896,888	\$ 967,499

- (1) The Amended and Restated Credit Agreement is scheduled to mature and the commitments thereunder will terminate on March 27, 2023, subject to extensions as set forth therein. These borrowings are reflected in the “3-5 Years” column and discussed in the financing activities section above. See Note 4, “Long-Term Debt and Finance Lease Liabilities” to our unaudited consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q.
- (2) Represents estimated interest payments through the March 27, 2023 maturity date of our Amended and Restated Credit Agreement based on the outstanding amounts as of September 29, 2019 and based on LIBOR rates in effect at the time of this report, net of interest rate swaps.
- (3) Represents estimated payments for finance and operating lease obligations as of September 29, 2019. Lease obligations are presented gross without offset for subtenant rentals. We have subtenant agreements under which we will receive \$1.7 million for the period of less than one year, \$2.8 million for years one to three, \$2.2 million for years four to five, and \$2.6 million for the period beyond five years.

We have other contractual commitments which were presented under Contractual Obligations in our Annual Report on Form 10-K for the fiscal year ended December 30, 2018, and for which there have not been material changes since that filing through September 29, 2019.

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 Deflation and Inflation

Deflation and inflation in the prices of food and other products we sell may periodically affect our sales, gross profit and gross margin. Food deflation across multiple categories, particularly in produce, could reduce sales growth and earnings if our competitors react by lowering their retail pricing and expanding their promotional activities, which can lead to retail deflation higher than cost deflation that could reduce our sales, gross profit margins and comparable store sales. Food inflation, when combined with reduced consumer spending, could also reduce sales, gross profit margins and comparable store sales. The short-term impact of deflation and inflation is largely dependent on whether or not the effects are passed through to our customers, which is subject to competitive market conditions.

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

Critical Accounting Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. These principles require us to make estimates and judgments that affect the reported amounts of assets, liabilities, sales and expenses, cash flow and related disclosure of contingent assets and liabilities. Our estimates include, but are not limited to, those related to inventory, lease assumptions, self-insurance reserves, sublease assumptions for closed stores, goodwill and intangible assets, impairment of long-lived assets, fair values of share-based awards and derivatives, 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 thirteen and thirty-nine weeks ended September 29, 2019, except as described in Note 5, "Leases" for the adoption of ASC 842. 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 December 30, 2018.

Recently Issued Accounting Pronouncements

See Note 2, "Summary of Significant Accounting Policies" to our accompanying unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

As described in Note 4, "Long-Term Debt and Finance Lease Liabilities" to our unaudited consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q, we have an Amended and Restated Credit Agreement that bears interest at a rate based in part on LIBOR. Accordingly, we are exposed to fluctuations in interest rates. Based on the \$515 million principal outstanding under our Amended and Restated Credit Agreement as of September 29, 2019, each hundred basis point change in LIBOR would result in a change in interest expense by \$5.2 million annually. We entered into an interest rate swap agreement in December 2017 to manage our cash flow associated with variable interest rates. The notional dollar amount of the four outstanding swaps at September 29, 2019 and December 30, 2018 was \$250.0 million under which we pay a fixed rate and received a variable rate of interest (cash flow swap). Taking into account the interest rate swaps, based on the \$515 million principal outstanding under our Amended and Restated Credit Agreement as of September 29, 2019, each hundred basis point change in LIBOR would result in a change in interest expense by \$2.7 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.

We do not enter into derivative financial instruments for trading purposes (see Note 11, "Derivative Financial Instruments" of our unaudited consolidated financial statements).

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 periods 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 Interim 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 our Interim Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures under the Exchange Act as of September 29, 2019, the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our Chief Executive Officer and our Interim 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 September 29, 2019, there were no changes in our internal controls over financial reporting that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings.

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

Securities Action

On March 4, 2016, a complaint was filed in the Superior Court for the State of Arizona against our company and certain of our directors and officers on behalf of a purported class of purchasers of shares of our common stock in our underwritten secondary public offering which closed on March 10, 2015 (the "March 2015 Offering"). The complaint purported to state claims under Sections 11, 12 and 15 of the Securities Act of 1933, as amended, based on an alleged failure by our company to disclose adequate information about produce price deflation in the March 2015 Offering documents. The complaint sought damages on behalf of the purported class in an unspecified amount, rescission, and an award of reasonable costs and attorneys' fees. On August 4, 2018, we reached an agreement in principle to settle these claims. The parties' settlement agreement was approved by the court on May 31, 2019 and the complaint was subsequently dismissed. The settlement was funded from our directors and officers liability insurance policy and did not have a material impact on our consolidated financial statements.

"Phishing" Scam Actions

In April 2016, four complaints were filed, two in the federal courts of California, one in the Superior Court of California and one in the federal court in the District of Colorado, each on behalf of a purported class of our current and former team members whose personally identifiable information ("PII") was inadvertently disclosed to an unauthorized third party that perpetrated an email "phishing" scam against one of our team members. The complaints allege we failed to properly safeguard the PII in accordance with applicable law. The complaints seek damages on behalf of the purported class in unspecified amounts, attorneys' fees and litigation expenses. After consolidation and transfer of the cases to the federal court in the District of Arizona, the Judicial Panel on Multidistrict Litigation granted our motion to stay proceedings in the case pending a U.S. Supreme Court ruling on the question of whether arbitration agreements like those signed by each of the named plaintiffs are enforceable. On May 21, 2018, the Supreme Court issued its opinion in *Epic Systems Corp. v. Lewis* and upheld enforceability of arbitration agreements containing class action waivers, like the ones the named plaintiffs signed in this matter. On March 1, 2019, a number of individual plaintiffs filed arbitration demands. On May 15, 2019, certain other plaintiffs filed a second amended class action complaint in the District of Arizona, alleging that certain subclasses of team members are not subject to our arbitration agreement and attempts to pursue those team members' claims in federal court. In late August 2019, we reached an agreement in principle to settle the majority of these claims. Primary funding for the settlement will come from our cyber insurance policy, and the settlement will not have a material impact on our consolidated financial statements. A small group of less than fifteen (15) individual claimants will proceed with arbitration of their claims. We intend to defend the arbitrations vigorously, but it is not possible at this time to reasonably estimate the outcome of, or any potential liability from, the arbitrations.

Proposition 65 Coffee Action

On April 13, 2010, an organization named Council for Education and Research on Toxics ("CERT") filed a lawsuit in the Superior Court of the State of California, County of Los Angeles, against nearly 80 defendants who manufacture, package, distribute or sell brewed coffee, including Sprouts. CERT alleges that the defendants failed to provide warnings for their coffee products of exposure to the chemical acrylamide as required under California Health and Safety Code section 25249.5, the California Safe Drinking Water and Toxic Enforcement Act of 1986, better known as Proposition 65. CERT seeks equitable relief, including providing warnings to consumers of coffee products, as well as civil penalties.

Our company, as part of a joint defense group, asserted multiple defenses against the lawsuit. On May 7, 2018, the trial court issued a ruling adverse to defendants on these defenses to liability. On June 15, 2018, before the court tried damages, remedies and attorneys' fees, California's Office of Environmental Health Hazard Assessment ("OEHHA") published a proposal to amend Proposition 65's implementing regulations by adding a stand-alone sentence that reads as follows: "Exposures to listed chemicals in coffee created by and inherent in the processes of roasting coffee beans or brewing coffee do not pose a significant risk of cancer." The proposed regulation was subsequently modified and resubmitted, and has been finalized with an effective date of October 1, 2019. The litigation was stayed by the Court of Appeal of the State of California on October 12, 2018 pending completion of the regulation. The stay was lifted on June 24, 2019.

On July 11, 2019, the trial court set a briefing schedule for the defendants to move to amend their answers to assert the regulation as a complete defense to CERT's claims, and set a further status conference to determine the schedule for briefing that issue and CERT's numerous challenges to the validity of the regulation. If the court determines that the regulation applies to this case, and rejects CERT's challenges, the case will be dismissed. If the court determines that the regulation does not apply to this case, or upholds one or more of CERT's challenges, then the court will set the case for trial of the remaining issues – civil penalties and injunctive relief.

At this stage of the proceedings, prior to a trial on the remedies issues, Sprouts is unable to predict or reasonably estimate the potential loss or effect on our company or our operations. Accordingly, no loss contingency was recorded for this matter. If the court determines that the regulation does not apply to this case, the trial court has discretion to impose zero penalties against our company or to impose significant statutory penalties. Significant labeling or warning requirements that could potentially be imposed by the trial court may increase our costs and adversely affect sales of our coffee products. Furthermore, a future appellate court decision could reverse the trial court rulings. The outcome and the financial impact of settlement or the trial or appellate court rulings of the case to our company, if any, cannot be predicted.

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 December 30, 2018.

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

Issuer Purchases of Equity Securities

There was no share repurchase activity during the thirteen weeks ended September 29, 2019.

Item 6. Exhibits.

Exhibit Number	Description
10.1	<u>Employment Transition Agreement, dated August 1, 2019, by and between Sprouts Farmers Market, Inc. and Jim Nielsen (1)</u>
31.1	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
31.2	<u>Certification of Interim Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
32.1	<u>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</u>
32.2	<u>Certification of Interim Chief Financial Officer pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
101.INS	Inline XBRL Instance Document – the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.
101.SCH	Inline XBRL Taxonomy Extension Schema Document
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document
104	Cover Page Interactive Data File (embedded within the Inline XBRL document)
(1)	Filed as an exhibit to the Registrant's Current Report on Form 8-K filed with the SEC on August 1, 2019, and incorporated herein by reference.

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: October 31, 2019

By: /s/ Lawrence P. Molloy
Name: Lawrence P. Molloy
Title: Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

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Section 2: EX-31.1 (EX-31.1)

Exhibit 31.1

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

I, Jack L. Sinclair, certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: October 31, 2019

/s/ Jack L. Sinclair

Jack L. Sinclair
Chief Executive Officer
(Principal Executive Officer)

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Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

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

I, Lawrence P. Molloy, certify that:

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

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

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

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

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

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

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

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

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

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

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

Date: October 31, 2019

/s/ Lawrence P. Molloy

Lawrence P. Molloy
Interim Chief Financial Officer
(Principal Financial and Accounting Officer)

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Section 4: EX-32.1 (EX-32.1)

Exhibit 32.1

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

In connection with the quarterly report of Sprouts Farmers Market, Inc. (the "Company"), on Form 10-Q for the quarterly period ended September 29, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Jack L. Sinclair, Chief Executive Officer of the Company, certify, based on my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

Date: October 31, 2019

/s/ Jack L. Sinclair

Jack L. Sinclair

Chief Executive Officer

(Principal Executive Officer)

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

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Section 5: EX-32.2 (EX-32.2)

Exhibit 32.2

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

In connection with the quarterly report of Sprouts Farmers Market, Inc. (the "Company"), on Form 10-Q for the quarterly period ended September 29, 2019 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Lawrence P. Molloy, Interim Chief Financial Officer of the Company, certify, based on my knowledge, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

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

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

Date: October 31, 2019

/s/ Lawrence P. Molloy

Lawrence P. Molloy

Interim Chief Financial Officer

(Principal Financial and Accounting Officer)

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

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