Sprouts Farmers Market, Inc.
Form 10-Q
August 02, 2018
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 1, 2018

Commission File Number: 001-36029

Sprouts Farmers Market, Inc.

(Exact name of registrant as specified in its charter)

Delaware	32-0331600
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

5455 East High Street, Suite 111

Phoenix, Arizona 85054

(Address of principal executive offices and zip code)

(480) 814-8016

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T

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

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

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
Emerging growth company		

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

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

As of August 1, 2018, the registrant had 127,086,822 shares of common stock, $0.001 par value per share, outstanding.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED JULY 1, 2018

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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," "poten "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 31, 2017, and our other filings with the Securities and Exchange Commission. Furthermore, such forward-looking statements speak only as of the date of this report. Except as required by law, we undertake no obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements.

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

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)

	July 1, 2018	December 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$23,174	$19,479
Accounts receivable, net	27,580	25,893
Inventories	250,564	229,542
Prepaid expenses and other current assets	28,696	24,593
Total current assets	330,014	299,507
Property and equipment, net of accumulated depreciation	776,323	713,031
Intangible assets, net of accumulated amortization	195,504	196,205
Goodwill	368,078	368,078
Other assets	13,850	4,782
Total assets	$1,683,769	$1,581,603
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and other accrued liabilities	$265,578	$244,853
Accrued salaries and benefits	38,410	45,623
Current portion of capital and financing lease obligations	14,362	9,238
Total current liabilities	318,350	299,714
Long-term capital and financing lease obligations	121,647	125,489
Long-term debt	458,000	348,000
Other long-term liabilities	139,984	130,640
Deferred income tax liability	44,616	27,066
Total liabilities	1,082,597	930,909
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, 127,570,117 shares issued and outstanding, July 1, 2018; 132,823,981 shares issued and outstanding, December 31, 2017	126	132

Additional paid-in capital	636,445	620,788
Accumulated other comprehensive income (loss)	3,702	(784)
(Accumulated deficit) retained earnings	(39,101)	30,558
Total stockholders’ equity	601,172	650,694
Total liabilities and stockholders’ equity	$1,683,769	$1,581,603

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		Twenty-six Weeks Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Net sales	$1,321,693	$1,183,975	$2,608,889	$2,314,620
Cost of sales, buying and occupancy	941,281	841,989	1,841,425	1,635,348
Gross profit	380,412	341,986	767,464	679,272
Direct store expenses	272,973	236,087	535,568	465,145
Selling, general and administrative expenses	43,437	38,189	84,884	70,357
Store pre-opening costs	2,275	4,141	5,595	7,599
Store closure and other costs	26	98	36	189
Income from operations	61,701	63,471	141,381	135,982
Interest expense	(6,544)	(5,100)	(12,609)	(9,838)
Other income	117	131	325	226
Income before income taxes	55,274	58,502	129,097	126,370
Income tax provision	(13,565)	(17,534)	(20,764)	(39,115)
Net income	$41,709	$40,968	$108,333	$87,255
Net income per share:				
Basic	$0.32	$0.30	$0.83	$0.64
Diluted	$0.32	$0.29	$0.82	$0.62
Weighted average shares outstanding:				
Basic	129,423	136,796	130,924	136,933
Diluted	130,012	139,493	131,949	139,847

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		Twenty-six Weeks Ended	
	July 1, 2018	July 2, 2017	July 1, 2018	July 2, 2017
Net income	$41,709	$40,968	$108,333	$87,255
Other comprehensive income, net of tax				
Unrealized gain on cash flow hedging activities, net of income tax of $404, $0, $1,552 and $0	1,166	—	4,486	—
Total other comprehensive income	$1,166	$—	$4,486	$—
Comprehensive income	$42,875	$40,968	$112,819	$87,255

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)

	Shares	Common Stock	Additional Paid In Capital	(Accumulated deficit) Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
Balances at January 1, 2017	140,002,242	$ 140	$ 597,269	$ 75,500	$ —	$ 672,909
Net income	—	—	—	158,440	—	158,440
Other comprehensive income (loss)	—	—	—	—	(784)	(784)
Issuance of shares under stock plans	2,144,669	2	9,298	—	—	9,300
Repurchase and retirement of common stock	(9,696,819)	(10)	—	(203,382)	—	(203,392)
Equity-based compensation	—	—	14,221	—	—	14,221
Balances at December 31, 2017	132,450,092	$ 132	$ 620,788	$ 30,558	$ (784)	$ 650,694
Net income				108,333		108,333
Other comprehensive income (loss)					4,486	4,486
Issuance of shares under stock plans	2,398,730	2	7,027			7,029
Repurchase and retirement of common stock	(7,692,571)	(8)		(177,992)		(178,000)
Equity-based compensation			8,630			8,630
Balances at July 1, 2018	127,156,251	$ 126	$ 636,445	$ (39,101)	$ 3,702	601,172

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(UNAUDITED)

(IN THOUSANDS)

	Twenty-six Weeks Ended	
	July 1, 2018	July 2, 2017
Cash flows from operating activities		
Net income	$108,333	$87,255
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	53,829	46,142
Accretion of asset retirement obligation and closed store reserve	147	94
Amortization of financing fees and debt issuance costs	517	231
Loss on disposal of property and equipment	236	356
Equity-based compensation	8,630	6,239
Deferred income taxes	17,550	18,039
Changes in operating assets and liabilities:		
Accounts receivable	(2,954)	4,106
Inventories	(21,022)	(13,940)
Prepaid expenses and other current assets	(1,312)	(1,549)
Other assets	(6,745)	(2,450)
Accounts payable and other accrued liabilities	10,379	24,996
Accrued salaries and benefits	(7,154)	2,051
Other long-term liabilities	10,674	8,313
Cash flows from operating activities	171,108	179,883
Cash flows from investing activities		
Purchases of property and equipment	(103,936)	(117,753)
Proceeds from sale of property and equipment	1	30
Cash flows used in investing activities	(103,935)	(117,723)
Cash flows from financing activities		
Proceeds from revolving credit facilities	140,000	85,000
Payments on revolving credit facilities	(30,000)	(30,000)
Payments on capital and financing lease obligations	(2,135)	(2,068)
Payments of deferred financing costs	(2,131)	—
Cash from landlords related to capital and financing lease obligations	2,113	1,325
Repurchase of common stock	(178,000)	(120,000)
Proceeds from exercise of stock options	6,734	5,932
Other	(59)	—
Cash flows used in financing activities	(63,478)	(59,811)
Increase in cash and cash equivalents	3,695	2,349
Cash and cash equivalents at beginning of the period	19,479	12,465
Cash and cash equivalents at the end of the period	$23,174	$14,814

Supplemental disclosure of cash flow information		
Cash paid for interest	$12,292	$9,438
Cash paid for income taxes	12,291	19,595
Supplemental disclosure of non-cash investing and financing activities		
Property and equipment in accounts payable	$27,959	$16,358
Property acquired through capital and financing lease obligations	7,452	9,774

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

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

1. Basis of Presentation

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

The accompanying unaudited consolidated financial statements include the accounts of the Company in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial statements and are in the form prescribed by the Securities and Exchange Commission in instructions to Form 10-Q and Rule 10-01 of Regulation S-X. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair statement of the Company's financial position, results of operations and cash flows for the periods indicated. All material intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for any other interim period or for a full fiscal year. The information included in these consolidated financial statements and notes thereto should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations included herein and Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2017 ("fiscal year 2017") included in the Company's Annual Report on Form 10-K, filed on February 22, 2018.

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 30, 2018 ("fiscal year 2018") and fiscal year 2017 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

The Company has adopted Accounting Standards Codification (“ASC”) 606, “Revenue from Contracts with Customers” in the first quarter of fiscal year 2018, with a date of initial application of January 1, 2018, using the modified retrospective approach. Comparative information presented has not been adjusted and continues to be reported under ASC 605.

The Company applied ASC 606 to all of its contracts with customers. As a result of the adoption, there is no impact to any financial statement line item, and the Company has recorded no impact to opening retained earnings as of January 1, 2018.

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, any contract performance obligations, or any material costs to obtain or fulfill a contract as of July 1, 2018. The Company had a net gift card liability balance of $7.6 million as of July 1, 2018 and $13.1 million as of December 31, 2017. During the twenty-six weeks ended July 1, 2018, the Company recognized $12.0 million in sales related to gift cards redeemed by customers.

Revenue is recognized at the point of sale. The Company’s performance obligations are satisfied upon the transfer of goods to the customer, at the point of sale, and payment from customers is also due at the time of sale. Proceeds from the sale of gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer and the performance obligation is satisfied by the Company.

The nature of goods the Company transfers to customers at the point of sale are inventories, consisting of merchandise purchased for resale.

Recently Adopted Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers.” ASU No. 2014-09 provides guidance for revenue recognition. The standard’s core principle is that a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under current guidance. These may include identifying performance obligations in the contract, and estimating the amount of variable consideration to include in the transaction price attributable to each separate performance obligation. Subsequent to the initial standards, the FASB has also issued several ASUs to clarify specific revenue recognition topics. The Company adopted ASC 606 effective January 1, 2018 using the modified retrospective approach. As noted above, there is no impact to any financial statement line item as a result of the adoption, and the Company has recorded no impact to opening retained earnings as of January 1, 2018. The Company has added additional disclosures of disaggregated revenue by type in Note 13, “Segments.”

In March 2016, the FASB issued ASU No. 2016-04, “Liabilities-Extinguishments of Liabilities (Subtopic 405-20): Recognition of breakage for certain prepaid stored-value products.” ASU No. 2016-04 provides a narrow scope exception to the guidance in Subtopic 405-20 to require that stored-value breakage be accounted for consistently with the breakage guidance in Topic 606. The amendments in this update contain specific guidance for derecognition of prepaid stored-value product liabilities, thereby eliminating the current and potential future diversity. The guidance was effective for the Company for its fiscal year 2018. The Company adopted this guidance using the modified retrospective approach. As noted above, there is no impact to any financial statement line item as a result of the adoption, and the Company recorded no impact to opening retained earnings as of January 1, 2018.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." This update provides clarifications on the cash flow classification for eight specific cash flow issues: debt prepayment or debt extinguishment costs; settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; contingent consideration payments made after a business combination; proceeds from the settlement of insurance claims; proceeds from the settlement of corporate-owned life insurance policies (COLIs) (including bank-owned life insurance policies (BOLIs)); distributions received from equity method investees; beneficial interests in securitization transactions; and separately identifiable cash flows and application of the predominance principle. Adoption of this guidance took place during the first quarter of fiscal year 2018, using the retrospective transition method, and the adoption had no impact on the Company's consolidated financial statements or disclosures.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting." The amendments in this update provide guidance about which changes to the terms or conditions of a share-based award require an entity to apply modification accounting in Topic 718. Adoption of this guidance took place prospectively in fiscal year 2018, and the adoption did not have an impact on the Company's consolidated financial statements or disclosures.

Recently Issued Accounting Pronouncements Not Yet Adopted

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

In 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.

No other new accounting pronouncements issued or effective during the twenty-six weeks ended July 1, 2018 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.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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

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 July 1, 2018 and December 31, 2017:

July 1, 2018	Level 1	Level 2	Level 3	Total
Long-term debt	$ —	$458,000	$ —	$458,000
Total liabilities	$ —	$458,000	$ —	$458,000
Interest rate swap asset	$ —	$4,990	$ —	$4,990
Total assets	$ —	$4,990	$ —	$4,990

December 31, 2017	Level 1	Level 2	Level 3	Total
Long-term debt	$ —	$348,000	$ —	$348,000
Interest rate swap liability	—	1,064	—	1,064
Total liabilities	$ —	$349,064	$ —	$349,064

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.

Cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable and other 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 July 1, 2018 and December 31, 2017.

4. Long-Term Debt

A summary of long-term debt is as follows:

			As of	
Facility	Maturity	Interest Rate	July 1, 2018	December 31, 2017

Senior secured debt				
$700.0 million Credit Agreement	March 27, 2023	Variable	$458,000	$—
Former Credit Facility	April 17, 2020	Variable	—	348,000
Total debt			458,000	348,000
Long-term debt			$458,000	$348,000

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.

SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

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 July 1, 2018.