

SPARTAN STORES INC  
Form 10-Q  
October 12, 2006

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**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 9, 2006.

**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: 000-31127

**SPARTAN STORES, INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Michigan**

(State or Other Jurisdiction  
of Incorporation or Organization)

**38-0593940**

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

**850 76<sup>th</sup> Street, S.W.**

**P.O. Box 8700**

**Grand Rapids, Michigan**

(Address of Principal Executive Offices)

**49518**

(Zip Code)

**(616) 878-2000**

(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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act).

Yes  No

As of October 2, 2006 the registrant had 21,493,957 outstanding shares of common stock, no par value.

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## FORWARD-LOOKING STATEMENTS

The matters discussed in this Quarterly Report on Form 10-Q include "forward-looking statements" about the plans, strategies, objectives, goals or expectations of Spartan Stores, Inc. (together with its subsidiaries, "Spartan Stores"). These forward-looking statements are identifiable by words or phrases indicating that Spartan Stores or management "expects," "anticipates," "projects," "plans," "believes," "estimates," "intends," is "optimistic" or "confident" that a particular occurrence "will," "may," "could," "should" or "will likely" result or that a particular event "will," "may," "could," "should" or "will likely" occur in the future, that the "outlook" or "trend" is toward a particular result or occurrence, that a development is a "priority" or similarly stated expectations. Accounting estimates, such as those described under the heading "Critical Accounting Policies" in Item 2 of this Form 10-Q, are inherently forward-looking. You should not place undue reliance on these forward-looking statements, which speak only as of the date of this Quarterly Report.

In addition to other risks and uncertainties described in connection with the forward-looking statements contained in this Quarterly Report on Form 10-Q, Spartan Stores' Annual Report on Form 10-K for the year ended March 25, 2006 (in particular, you should refer to the discussion of "Risk Factors" in Item 1A of our Annual Report on Form 10-K), and other periodic reports filed with the Securities and Exchange Commission, there are many important factors that could cause actual results to differ materially. Our ability to strengthen our retail-store performance; maintain or grow sales; maintain or increase gross margin; anticipate and successfully respond to openings of competitors; maintain and improve customer and supplier relationships; realize expected benefits of new relationships; realize growth opportunities; expand our customer base; reduce operating costs; sell on favorable terms assets classified as held for sale; generate cash; continue to meet the terms of our debt covenants; and implement the other programs, plans, priorities, strategies, objectives, goals or expectations described in this Quarterly Report, our press releases and our public comments will be affected by changes in economic conditions generally or in the markets and geographic areas that we serve, adverse effects of the changing food and distribution industries and other factors including, but not limited to, those discussed below.

Anticipated future sales are subject to competitive pressures from many sources. Our Distribution and Retail businesses compete with many supercenters, warehouse discount stores, supermarkets, pharmacies and product manufacturers. Future sales will be dependent on the number of retail stores that we own and operate, our ability to retain and add to the retail stores to whom we distribute, competitive pressures in the retail industry generally and our geographic markets specifically and our ability to implement effective new marketing and merchandising programs. Competitive pressures in these and other business segments may result in unexpected reductions in sales volumes, product prices or service fees.

Our operating and administrative expenses, and as a result our net earnings, may be adversely affected by unexpected costs associated with, among other factors: difficulties in the operation of our business segments; future business acquisitions; adverse effects on business relationships with independent retail grocery store customers; difficulties in the retention or hiring of employees; labor shortages, stoppages or disputes; business and asset divestitures; increased transportation or fuel costs; current or future lawsuits and administrative proceedings; and losses of, or financial difficulties of, customers or suppliers. Our future costs for pension and postretirement benefit costs may be adversely affected by changes in actuarial assumptions and methods, investment return and the composition of the group of employees and retirees covered, changes in our business that result in a withdrawal liability under multi-employer plans, and the actions and contributions of other employers who participate in multi-employer plans to which we contribute. Our operating and administrative expenses, net earnings and cash flow could also be adversely affected by changes in our sales mix. Our ongoing cost reduction initiatives and changes in our marketing and merchandising programs may not be as successful as we anticipate. Acts of terrorism or war have in the past and may in the future result in considerable economic and political uncertainties that could have adverse

effects on consumer buying behavior, fuel costs, shipping and transportation, product imports and other factors affecting our company and the grocery industry generally. Our asset impairment and exit cost provisions are estimates and actual costs may be more or less than these estimates.

Our future interest expense and income also may differ from current expectations, depending upon, among other factors: the amount of additional borrowings; changes in our borrowing agreements; changes in the interest rate environment; and changes in the amount of fees received or paid. The availability of our secured loan agreement depends on compliance with the terms of the loan agreement.

Our ability to realize increased sales and earnings as a result of our recent acquisition of certain of the assets of D&W Food Centers, Inc. ("D&W") depends on our ability to successfully integrate the acquired assets and implement our plans and business practices. Our ability to identify and realize opportunities to grow through acquisition is not assured and depends on a variety of factors, not all of which are within our control.

Our adoption of a dividend policy does not commit the Board of Directors to declare future dividends. Each future dividend will be considered and declared by the Board of Directors in its discretion. Whether the Board of Directors continues to declare dividends depends on a number of factors, including our future financial condition and profitability and compliance with the terms of our credit facilities.

This section is intended to provide meaningful cautionary statements for purposes of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. This should not be construed as a complete list of all economic, competitive, governmental, technological and other factors that could adversely affect our expected consolidated financial position, results of operations or liquidity. We undertake no obligation to update or revise our forward-looking statements to reflect developments that occur or information obtained after the date of this Quarterly Report.

**PART I**  
**FINANCIAL INFORMATION**

**ITEM 1. Financial Statements**

**SPARTAN STORES, INC. AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**

(In thousands)  
(Unaudited)

| <u>Assets</u>  | <u>September 9,<br/>2006</u> | <u>March 25,<br/>2006</u> |
|--|------------------------------|---------------------------|
| <b>Current assets</b>  |                              |                           |
| Cash and cash equivalents  | \$ 10,221                    | \$ 7,655                  |
| Accounts receivable, net   | 47,369                       | 45,280                    |
| Inventories, net   | 119,840                      | 95,892                    |
| Prepaid expenses and other current assets                          | 6,889                        | 5,433                     |
| Deferred taxes on income   | 7,334                        | 6,801                     |
| Property and equipment held for sale                               | 5,050                        | 6,634                     |
| <b>Total current assets</b>  | <b>196,703</b>               | <b>167,695</b>            |
| <b>Other assets</b>  |                              |                           |
| Goodwill   | 141,216                      | 72,555                    |
| Deferred taxes on income   | 3,343                        | 9,061                     |
| Other, net   | 14,592                       | 14,108                    |
| <b>Total other assets</b>  | <b>159,151</b>               | <b>95,724</b>             |
| <b>Property and equipment, net</b>                                 | <b>138,751</b>               | <b>115,178</b>            |
| <b>Total assets</b>  | <b>\$ 494,605</b>            | <b>\$ 378,597</b>         |
| <br><b><u>Liabilities and Shareholders' Equity</u></b>             |                              |                           |
| <b>Current liabilities</b>   |                              |                           |
| Accounts payable   | \$ 109,773                   | \$ 90,992                 |
| Accrued payroll and benefits                                       | 27,252                       | 29,423                    |
| Other accrued expenses   | 19,455                       | 18,356                    |
| Current portion of exit costs                                      | 8,161                        | 6,513                     |
| Current maturities of long-term debt and capital lease obligations | 5,367                        | 1,675                     |
| <b>Total current liabilities</b>                                   | <b>170,008</b>               | <b>146,959</b>            |
| <b>Long-term liabilities</b>                                       |                              |                           |
| Postretirement benefits  | 8,671                        | 8,702                     |

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|  |            |            |
|--|------------|------------|
| Other long-term liabilities  | 11,357     | 4,700      |
| Exit costs   | 27,764     | 8,804      |
| Long-term debt and capital lease obligations   | 118,782    | 64,015     |
|  | <hr/>      | <hr/>      |
| <b>Total long-term liabilities</b>   | 166,574    | 86,221     |
| <b>Shareholders' equity</b>  |            |            |
| Common stock, voting, no par value; 50,000 shares authorized; 21,476 and 21,023 shares outstanding | 123,105    | 123,256    |
| Preferred stock, no par value, 10,000 shares authorized; no shares outstanding                     | -          | -          |
| Deferred stock-based compensation  | -          | (2,873)    |
| Accumulated other comprehensive loss   | (276)      | (276)      |
| Retained earnings  | 35,194     | 25,310     |
|  | <hr/>      | <hr/>      |
| <b>Total shareholders' equity</b>  | 158,023    | 145,417    |
|  | <hr/>      | <hr/>      |
| <b>Total liabilities and shareholders' equity</b>  | \$ 494,605 | \$ 378,597 |
|  | <hr/>      | <hr/>      |

*See accompanying notes to condensed consolidated financial statements.*

**SPARTAN STORES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF EARNINGS**

(In thousands, except per share data)

(Unaudited)

|   | 12 Weeks Ended       |                       | 24 Weeks Ended       |                       |
|---|----------------------|-----------------------|----------------------|-----------------------|
|   | September 9,<br>2006 | September 10,<br>2005 | September 9,<br>2006 | September 10,<br>2005 |
| <b>Net sales</b>  | \$ 559,384           | \$ 485,541            | \$ 1,087,400         | \$ 944,861            |
| <b>Cost of sales</b>  | 447,409              | 391,995               | 871,925              | 765,508               |
| <b>Gross margin</b>   | 111,975              | 93,546                | 215,475              | 179,353               |
| <b>Operating expenses</b>                                       |                      |                       |                      |                       |
| Selling, general and administrative expenses                    | 94,252               | 81,303                | 186,432              | 160,842               |
| Provision for asset impairments and exit costs                  | -                    | -                     | 4,464                | 270                   |
| <b>Total operating expenses</b>                                 | 94,252               | 81,303                | 190,896              | 161,112               |
| <b>Operating earnings</b>                                       | 17,723               | 12,243                | 24,579               | 18,241                |
| <b>Other income and expenses</b>                                |                      |                       |                      |                       |
| Interest expense  | 2,952                | 1,763                 | 5,809                | 3,532                 |
| Other, net  | 238                  | (3)                   | 206                  | (55)                  |
| <b>Total other income and expenses</b>                          | 3,190                | 1,760                 | 6,015                | 3,477                 |
| <b>Earnings before income taxes and discontinued operations</b> | 14,533               | 10,483                | 18,564               | 14,764                |
| Income taxes  | 5,085                | 3,415                 | 6,498                | 4,881                 |
| <b>Earnings from continuing operations</b>                      | 9,448                | 7,068                 | 12,066               | 9,883                 |
| <b>Loss from discontinued operations, net of taxes</b>          | (114)                | (215)                 | (43)                 | (378)                 |
| <b>Net earnings</b>   | \$ 9,334             | \$ 6,853              | \$ 12,023            | \$ 9,505              |
| <b>Basic earnings (loss) per share:</b>                         |                      |                       |                      |                       |
| Earnings from continuing operations                             | \$ 0.46              | \$ 0.34               | \$ 0.58              | \$ 0.48               |
| Loss from discontinued operations                               | (0.01)               | (0.01)                | -                    | (0.02)                |
| <b>Net earnings</b>   | \$ 0.45              | \$ 0.33               | \$ 0.58              | \$ 0.46               |

**Diluted earnings (loss) per share:**



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|                                     |    |        |    |        |    |      |    |        |
|-------------------------------------|----|--------|----|--------|----|------|----|--------|
| Earnings from continuing operations | \$ | 0.45   | \$ | 0.33   | \$ | 0.57 | \$ | 0.47   |
| Loss from discontinued operations   |    | (0.01) |    | (0.01) |    | -    |    | (0.02) |
| <hr/>                               |    |        |    |        |    |      |    |        |
| Net earnings                        | \$ | 0.44   | \$ | 0.32   | \$ | 0.57 | \$ | 0.45   |
| <hr/>                               |    |        |    |        |    |      |    |        |

**Weighted average shares outstanding:**

|         |        |        |        |        |
|---------|--------|--------|--------|--------|
| Basic   | 20,796 | 20,808 | 20,756 | 20,722 |
| Diluted | 21,191 | 21,437 | 21,148 | 21,338 |

*See accompanying notes to condensed consolidated financial statements.*

**SPARTAN STORES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY**  
(In thousands)  
(Unaudited)

|  | Shares<br>Outstanding | Common<br>Stock   | Deferred<br>Stock-Based<br>Compensation | Accumulated<br>Other<br>Comprehensive<br>Loss | Retained<br>Earnings | Total             |
|--|-----------------------|-------------------|---|---|----------------------|-------------------|
| <b>Balance - March 26, 2006</b>  | 21,023                | \$ 123,256        | \$ (2,873)                              | \$ (276)                                      | \$ 25,310            | \$ 145,417        |
| Reclassification of deferred stock-based compensation upon adoption of SFAS 123(R) |                       | (2,873)           | 2,873                                   | -   | -                    | -                 |
| <b>Comprehensive income, net of tax:</b>   |                       |                   |   |   |                      |                   |
| Net earnings   | -                     | -                 | -                                       | -   | 12,023               | 12,023            |
| Dividends - \$.05 per share  | -                     | -                 | -                                       | -   | (2,139)              | (2,139)           |
| Stock-based employee compensation  | -                     | 919               | -                                       | -   | -                    | 919               |
| Issuances of common stock and related tax benefit on stock option exercises        | 265                   | 1,472             | -                                       | -   | -                    | 1,472             |
| Issuances of restricted stock and related income tax benefit                       | 250                   | 705               | -                                       | -   | -                    | 705               |
| Cancellations of restricted stock  | (62)                  | (374)             | -                                       | -   | -                    | (374)             |
| <b>Balance - September 9, 2006</b>   | <b>21,476</b>         | <b>\$ 123,105</b> | <b>\$ -</b>                             | <b>\$ (276)</b>                               | <b>\$ 35,194</b>     | <b>\$ 158,023</b> |

*See accompanying notes to condensed consolidated financial statements.*

**SPARTAN STORES, INC. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

|   | 24 Weeks Ended       |                       |
|---|----------------------|-----------------------|
|   | September 9,<br>2006 | September 10,<br>2005 |
| <b>Cash flows from operating activities</b>   |                      |                       |
| Net earnings  | \$ 12,023            | \$ 9,505              |
| Loss from discontinued operations   | 43                   | 378                   |
|   | 12,066               | 9,883                 |
| Earnings from continuing operations   | 12,066               | 9,883                 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |                      |                       |
| Provision for asset impairments and exit costs                                      | 4,464                | 270                   |
| Depreciation and amortization   | 10,290               | 10,154                |
| Postretirement benefits   | (31)                 | 676                   |
| Deferred taxes on income  | 6,216                | 4,786                 |
| Stock-based compensation expense  | 908                  | 366                   |
| Other   | 292                  | 405                   |
| Changes in operating assets and liabilities:  |                      |                       |
| Accounts receivable   | (2,571)              | 951                   |
| Inventories   | (19,423)             | (2,556)               |
| Prepaid expenses and other assets   | (113)                | (21)                  |
| Accounts payable  | 17,706               | 5,072                 |
| Accrued payroll and benefits  | (3,202)              | (6,425)               |
| Other accrued expenses and other liabilities  | (2,407)              | (1,186)               |
|   | 24,195               | 22,375                |
| <b>Net cash provided by operating activities</b>                                    | 24,195               | 22,375                |
| <b>Cash flows from investing activities</b>   |                      |                       |
| Purchases of property and equipment   | (12,074)             | (9,151)               |
| Net proceeds from the sale of assets  | 70                   | 10                    |
| Acquisition, net of cash acquired   | (47,922)             | -                     |
| Other   | 65                   | 384                   |
|   | (59,861)             | (8,757)               |
| <b>Net cash used in investing activities</b>  | (59,861)             | (8,757)               |
| <b>Cash flows from financing activities</b>   |                      |                       |
| Net proceeds from (payments on) revolving credit facility                           | 38,555               | (11,301)              |
| Repayment of long-term debt   | (1,040)              | (1,446)               |
| Proceeds from sale of common stock  | 1,464                | 305                   |
| Dividends paid  | (1,065)              | -                     |
|   | 37,914               | (12,442)              |
| <b>Net cash provided by (used in) financing activities</b>                          | 37,914               | (12,442)              |

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**Cash flows from discontinued operations**

**(Revised - See note 1)**

|   |                  |                  |
|---|------------------|------------------|
| Net cash used in operating activities                         | (1,370)          | (2,054)          |
| Net cash provided by investing activities                     | 1,688            | 1                |
| Net cash used in financing activities                         | -                | (509)            |
|   | <hr/>            | <hr/>            |
| <b>Net cash provided by (used in) discontinued operations</b> | <b>318</b>       | <b>(2,562)</b>   |
|   | <hr/>            | <hr/>            |
| <b>Net increase (decrease) in cash and cash equivalents</b>   | <b>2,566</b>     | <b>(1,386)</b>   |
| <b>Cash and cash equivalents at beginning of period</b>       | <b>7,655</b>     | <b>14,880</b>    |
|   | <hr/>            | <hr/>            |
| <b>Cash and cash equivalents at end of period</b>             | <b>\$ 10,221</b> | <b>\$ 13,494</b> |
|   | <hr/>            | <hr/>            |

*See accompanying notes to condensed consolidated financial statements.*

**SPARTAN STORES, INC. AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**Note 1**

**Basis of Presentation and Significant Accounting Policies**

The accompanying unaudited Condensed Consolidated Financial Statements include the accounts of Spartan Stores, Inc. and its subsidiaries ("Spartan Stores"). All significant intercompany accounts and transactions have been eliminated.

In the opinion of management, the accompanying condensed consolidated financial statements, taken as a whole, contain all adjustments, which are of a normal recurring nature, necessary to present fairly the financial position of Spartan Stores as of September 9, 2006 and the results of its operations and cash flows for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

*Revision*

In fiscal 2007 the operating, investing and financing portions of the cash flows attributable to discontinued operations have been separately disclosed, which in prior periods were reported on a combined basis as a single amount.

*Reclassifications*

Certain reclassifications have been made to the fiscal 2006 condensed consolidated balance sheet to conform to the fiscal 2007 presentation.

**Note 2**

**New Accounting Standards**

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment", that addresses the accounting for share-based payments to employees, including grants of employee stock options and other forms of share-based compensation. Under SFAS No. 123(R), it is no longer acceptable to account for share-based payments to employees using the intrinsic value method in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees". Instead, SFAS No. 123(R) requires that share-based payment transactions be accounted for using a fair value method and the related compensation cost recognized in the consolidated financial statements over the period that an employee is required to provide services in exchange for the award. SFAS No. 123(R) became effective for Spartan Stores at the beginning of fiscal 2007. The adoption of SFAS No. 123(R) and its effects are more fully described in Note 7, Stock-Based Compensation.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes", and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Further, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for Spartan Stores' at the beginning of fiscal year 2008. Spartan Stores is currently evaluating the impact of FIN 48 on its financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands

disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS No. 157 will become effective for Spartan Stores at the beginning of fiscal 2009. Spartan Stores is currently evaluating the impact, if any, that SFAS No. 157 will have on its financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106 and 132(R)", effective for public companies for fiscal years ending after December 15, 2006. SFAS No. 158 requires employers that sponsor a defined benefit postretirement plan to recognize the overfunded or underfunded status of defined benefit postretirement plans, including pension plans, in their balance sheets and to recognize changes in funded status through comprehensive income in the year in which the changes occur. This aspect of SFAS No. 158 is effective for Spartan Stores' current fiscal year ending March 31, 2007. The Statement also requires that employers measure plan assets and obligations as of the date of their year-end financial statements beginning with Spartan Stores' year ending March 28, 2009. Spartan Stores is currently evaluating the impact of the Statement on its financial statements.

### Note 3

#### Acquisition of Assets

On March 27, 2006, Spartan Stores acquired certain operating assets of D&W Food Centers, Inc. and D&W Associate Resources, LLC (together "D&W"), a privately-held Grand Rapids, Michigan-based retail grocery operator with retail stores located in West Michigan. The acquisition was made to obtain the store locations and operations of D&W, to diversify our retail offering with a more perishable oriented operation, to solidify and grow market share and to realize numerous synergies. The purchased assets included leasehold improvements, fixtures, tangible personal property, equipment, trademarks, trade names, intangible property and inventories. Spartan Stores paid a total cash purchase price of \$47.9 million for these operations. Spartan Stores assumed D&W's lease obligations for the 20 stores and the central commissary as well as specified contracts. Spartan Stores continues to operate 16 of the former D&W stores and the commissary. The funds used for the transaction were drawn under Spartan Stores' existing bank credit facilities. Additional information regarding the acquisition of D&W is included in Spartan Stores' Annual Report on Form 10-K for the year ended March 25, 2006.

#### *Pro forma financial information*

The following pro forma financial information illustrates estimated results of operations for the 12 weeks and 24 weeks ended September 10, 2005 after giving effect to the acquisition of D&W described above at the beginning of the period presented. The pro forma results are presented for comparative purposes only and do not purport to be indicative of results that would have actually been reported had the acquisition taken place on the date assumed, or to project Spartan Stores' results of operations which may be reported in the future.

(In thousands, except per share amounts)

|  | 12 Weeks Ended<br>Sept. 10, 2005 | 24 Weeks Ended<br>Sept. 10, 2005 |
|--|----------------------------------|----------------------------------|
|  | <hr/>                            | <hr/>                            |
| Net sales                                      | \$ 533,398                       | \$ 1,040,483                     |
| Earnings from continuing operations            | \$ 7,766                         | \$ 11,390                        |
| Earnings from continuing operations per share: |                                  |                                  |
| Basic  | \$ 0.37                          | \$ 0.55                          |
| Diluted  | \$ 0.36                          | \$ 0.53                          |
| Weighted average shares outstanding:           |                                  |                                  |
| Basic  | 20,808                           | 20,722                           |
| Diluted  | 21,437                           | 21,338                           |

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In the first quarter of fiscal 2007, Spartan Stores incurred approximately \$1.1 million, \$0.7 million after tax, in start-up costs related to training, remerchandising and rebranding the stores. These charges are included in "Selling, general and administrative expenses".



**Note 4****Asset Impairments and Exit Costs**

The Retail segment recognized charges of \$0.4 million for asset impairment costs and \$4.1 million for lease and related ancillary costs in the first quarter of fiscal 2007 related to the closure of two *Family Fare Supermarkets* stores and moving the central bakery operation into individual retail stores. Neither of the closed stores was acquired in the acquisition of D&W. The restructuring was based on Spartan Stores' comprehensive review of retail grocery store capacity in its markets following the completion of the acquisition of 16 D&W supermarkets on March 27, 2006, its desire to move the production of bakery products closer to the consumer, and the economics of its central bakery operation.

The following table provides the activity of exit costs for the 24 weeks ended September 9, 2006. Exit costs recorded in the Consolidated Balance Sheets are included in "Current portion of exit costs" in "Current liabilities" and "Exit costs" in "Long-term liabilities" based on when the obligations are expected to be paid.

(In thousands)

|  | Lease and<br>Ancillary Costs |
|--|------------------------------|
| Balance at March 26, 2006  | \$ 15,317                    |
| Exit costs assumed in acquisition of D&W   | 19,231                       |
| Provision for lease and related ancillary costs, net of estimated<br>sublease recoveries | 4,050                        |
| Payments, net of interest accretion  | (2,673)                      |
| Balance at September 9, 2006   | \$ 35,925                    |

**Note 5****Leases**

In conjunction with the D&W acquisition (see Note 3), Spartan Stores assumed the leases of the 16 retail stores that it continues to operate. Total future lease commitments of Spartan Stores under capital and operating leases in effect at September 9, 2006 are as follows:

(In thousands)

| Fiscal Year | Capital               |                        |          | Operating             |                        |           |
|-------------|-----------------------|------------------------|----------|-----------------------|------------------------|-----------|
|             | Used in<br>Operations | Subleased<br>to Others | Total    | Used in<br>Operations | Subleased<br>to Others | Total     |
| 2007        | \$ 1,847              | \$ 219                 | \$ 2,066 | \$ 11,967             | \$ 457                 | \$ 12,424 |
| 2008        | 3,571                 | 385                    | 3,956    | 22,288                | 727                    | 23,015    |
| 2009        | 3,579                 | -                      | 3,579    | 19,829                | 644                    | 20,473    |
| 2010        | 3,615                 | -                      | 3,615    | 17,654                | 553                    | 18,207    |
| 2011        | 3,664                 | -                      | 3,664    | 14,816                | 386                    | 15,202    |
| Thereafter  | 27,958                | -                      | 27,958   | 48,952                | 1,390                  | 50,342    |

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|  |           |        |           |            |          |            |
|--|-----------|--------|-----------|------------|----------|------------|
| Total                                      | 44,234    | 604    | 44,838    | \$ 135,506 | \$ 4,157 | \$ 139,663 |
| Interest                                   | (18,175)  | (41)   | (18,216)  |            |          |            |
| Present value of minimum lease obligations | 26,059    | 563    | 26,622    |            |          |            |
| Current portion                            | 1,274     | 376    | 1,650     |            |          |            |
| Long-term obligations at September 9, 2006 | \$ 24,785 | \$ 187 | \$ 24,972 |            |          |            |

**Note 6****Associate Retirement Plans**

The following table provides the components of net periodic pension and postretirement benefit costs for the second quarter and year-to-date periods ended September 9, 2006 and September 10, 2005:

(In thousands)

| <b>12 Weeks Ended</b>            | Pension Benefits |                   | SERP Benefits    |                   | Postretirement Benefits |                   |
|----------------------------------|------------------|-------------------|------------------|-------------------|-------------------------|-------------------|
|                                  | Sept. 9,<br>2006 | Sept. 10,<br>2005 | Sept. 9,<br>2006 | Sept. 10,<br>2005 | Sept. 9,<br>2006        | Sept. 10,<br>2005 |
| Service cost                     | \$ 771           | \$ 753            | \$ 11            | \$ 4              | \$ 56                   | \$ 53             |
| Interest cost                    | 610              | 577               | 9                | 8                 | 102                     | 96                |
| Expected return on plan assets   | (802)            | (723)             | -                | -                 | -                       | -                 |
| Net amortization and deferral    | (95)             | (98)              | 7                | 4                 | 1                       | (5)               |
| <b>Net periodic benefit cost</b> | <b>\$ 484</b>    | <b>\$ 509</b>     | <b>\$ 27</b>     | <b>\$ 16</b>      | <b>\$ 159</b>           | <b>\$ 144</b>     |

(In thousands)

| <b>24 Weeks Ended</b>            | Pension Benefits |                   | SERP Benefits    |                   | Postretirement Benefits |                   |
|----------------------------------|------------------|-------------------|------------------|-------------------|-------------------------|-------------------|
|                                  | Sept. 9,<br>2006 | Sept. 10,<br>2005 | Sept. 9,<br>2006 | Sept. 10,<br>2005 | Sept. 9,<br>2006        | Sept. 10,<br>2005 |
| Service cost                     | \$ 1,542         | \$ 1,506          | \$ 22            | \$ 8              | \$ 112                  | \$ 106            |
| Interest cost                    | 1,219            | 1,154             | 18               | 16                | 205                     | 192               |
| Expected return on plan assets   | (1,604)          | (1,446)           | -                | -                 | -                       | -                 |
| Net amortization and deferral    | (190)            | (196)             | 13               | 8                 | 1                       | (10)              |
| <b>Net periodic benefit cost</b> | <b>\$ 967</b>    | <b>\$ 1,018</b>   | <b>\$ 53</b>     | <b>\$ 32</b>      | <b>\$ 318</b>           | <b>\$ 288</b>     |

Spartan Stores expects to contribute \$2.2 million to its defined benefit plans in fiscal 2007 to meet the minimum funding requirements. As of September 9, 2006, \$1.2 million has been contributed. In fiscal 2006, Spartan Stores contributed \$3.2 million to its defined benefit plans.

**Note 7****Stock-Based Compensation**

Spartan Stores has two shareholder-approved stock incentive plans covering 3,200,000 shares of Spartan Stores' common stock, the Spartan Stores, Inc. 2001 Stock Incentive Plan (the "2001 Plan") and the Spartan Stores, Inc. Stock Incentive Plan of 2005 (the "2005 Plan"). The plans provide for the granting of incentive stock options, non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, stock awards, and other stock-based awards to directors, officers and other key associates. As of September 9, 2006, 124,812 shares remained unissued under the 2001 Plan, and 1,139,000 shares remained unissued under the 2005 Plan.

Prior to March 26, 2006, Spartan Stores accounted for the plans under the recognition and measurement provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations, as permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation." No stock-based compensation cost was reflected in the Consolidated Statements of Earnings for stock options as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The fair value of restricted stock was determined based on the average of the highest and lowest sales prices of Spartan Stores' common stock on the date of grant, and deferred stock-based compensation, representing the fair value of the stock at the measurement date of the award, was amortized to compensation expense over the vesting period.

Effective March 26, 2006, Spartan Stores adopted the fair value recognition provisions of SFAS No. 123(R), "Share-Based Payment", using the modified-prospective transition method. Under that transition method, compensation cost

recognized in the second quarter and year-to-date periods ended September 9, 2006 includes: (a) compensation cost for all share-based payments granted prior to, but not yet vested as of March 26, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, and (b) compensation cost for all share-based payments granted subsequent to March 26, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123(R). Upon adoption of SFAS No. 123(R), Spartan Stores elected to begin recognizing compensation expense using the straight-line amortization method for share-based awards granted on or after March 26, 2006, consistent with restricted stock awards granted prior to adoption. In accordance with the provisions of SFAS No. 123(R), results for prior periods have not been restated.

For share-based awards granted prior to adoption of SFAS No. 123(R), compensation expense was recognized over the stated vesting period, without regard for terms that accelerate vesting upon retirement. Upon adoption of SFAS No. 123(R), compensation expense will continue to be recognized under this method for awards granted prior to adoption. However, for awards granted on or after March 26, 2006, compensation expense will be recognized over the shorter of the vesting period or the period from the date of grant through the date the employee first becomes eligible to retire.

As a result of adopting SFAS No. 123(R) on March 26, 2006, Earnings before income taxes, Earnings from continuing operations and Net earnings for the 12 weeks ended September 9, 2006 are \$0.1 million lower than if Spartan Stores had continued to account for share-based compensation under APB Opinion No. 25. Basic and diluted earnings per share for the 12 weeks ended September 9, 2006 would have been \$0.45 and \$0.44, respectively, had Spartan Stores not adopted SFAS No. 123(R), compared to reported basic and diluted earnings per share of \$0.45 and \$0.44, respectively. For the 24 weeks ended September 9, 2006, Earnings before income taxes are \$0.3 million lower and Earnings from continuing operations and Net earnings are \$0.2 million lower, respectively, than if Spartan Stores had continued to account for share-based compensation under APB Opinion No. 25. Basic and diluted earnings per share for the 24 weeks ended September 9, 2006 would have been \$0.59 and \$0.57, respectively, had Spartan Stores not adopted SFAS No. 123(R), compared to reported basic and diluted earnings per share of \$0.58 and \$0.57, respectively.

The following table illustrates the effect on net earnings and earnings per share as if share-based compensation expense for the 12 and 24 weeks ended September 10, 2005 had been determined based on the fair value recognition provisions of SFAS No. 123(R):

(In thousands, except per share data)

|   | 12 Weeks Ended<br>September 10,<br>2005 | 24 Weeks Ended<br>September 10,<br>2005 |
|---|---|---|
| Net earnings, as reported   | \$ 6,853                                | \$ 9,505                                |
| Deduct: Total stock-based employee compensation expense<br>determined under fair value based method for all awards, net of<br>related tax effects | (89)                                    | (169)                                   |
| Pro forma net earnings  | \$ 6,764                                | \$ 9,336                                |
| Basic earnings per share - as reported  | \$ 0.33                                 | \$ 0.46                                 |
| Basic earnings per share - pro forma  | 0.33                                    | 0.45                                    |

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|  |    |      |    |      |
|--|----|------|----|------|
| Diluted earnings per share - as reported | \$ | 0.32 | \$ | 0.45 |
| Diluted earnings per share - pro forma   |    | 0.32 |    | 0.44 |

Stock option awards are generally granted with an exercise price equal to the market value of Spartan Stores common stock at the date of grant, vest and become exercisable in 25 percent increments over a four-year service period and have a maximum contractual term of 10 years. Upon a "Change in Control", as defined by the Plan, all outstanding options vest immediately. The fair value of each stock option grant is estimated on the date of grant

using the Black-Scholes option-pricing model. Expected volatility was determined based upon a combination of historical volatility of Spartan Stores common stock and the expected volatilities of guideline companies that are comparable to Spartan Stores in most significant respects. The expected term of options granted is determined using the "simplified method" as described in SEC Staff Accounting Bulletin No. 107 that uses the following formula:  $((\text{vesting term} + \text{original contract term})/2)$ . The risk-free interest rate was based on the U.S. Treasury yield curve in effect at the time of grant, using U.S. constant maturities with remaining terms equal to the expected term. Expected dividend yield is based on historical dividend payments.

The following weighted average assumptions were used to estimate the fair value of stock options at the date of grant using the Black-Scholes option-pricing model:

|                         | 24 Weeks Ended       |                       |
|-------------------------|----------------------|-----------------------|
|                         | September 9,<br>2006 | September 10,<br>2005 |
| Dividend yield          | 1.46%                | 0.00%                 |
| Expected volatility     | 30.43%               | 57.73%                |
| Risk-free interest rate | 5.05%                | 3.86%                 |
| Expected life of option | 6.25 years           | 7 years               |

The following table summarizes stock option activity for the 24 weeks ended September 9, 2006:

|   | Shares<br>Under<br>Options | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life Years | Aggregate<br>Intrinsic<br>Value<br>(In thousands) |
|---|----------------------------|---------------------------------------|---|---|
| <b>Options outstanding at March 25, 2006</b>                          | 1,003,943                  | \$ 8.01                               |   |   |
| Granted   | 173,750                    | 13.70                                 |   |   |
| Exercised   | (340,447)                  | 6.53                                  |   |   |
| Cancelled   | (29,152)                   | 10.26                                 |   |   |
| <b>Options outstanding at September 9, 2006</b>                       | <b>808,094</b>             | <b>\$ 9.77</b>                        | <b>6.79</b>   | <b>\$ 6,318</b>                                   |
| <b>Vested and expected to vest in the future at September 9, 2006</b> | <b>772,872</b>             | <b>\$ 9.69</b>                        | <b>6.64</b>   | <b>\$ 6,086</b>                                   |
| <b>Options exercisable at September 9, 2006</b>                       | <b>426,581</b>             | <b>\$ 10.55</b>                       | <b>5.33</b>   | <b>\$ 3,003</b>                                   |

The weighted average grant-date fair value of stock options granted during the 24 weeks ended September 9, 2006 and September 10, 2005 was \$4.73 and \$7.05, respectively. The total intrinsic value of stock options exercised during the 24 weeks ended September 9, 2006 and September 10, 2005 was \$2.9 million and \$0.2 million, respectively. Cash received from option exercises was \$1.5 million and \$0.1 million during the 24 weeks ended September 9, 2006 and September 10, 2005, respectively.

Spartan Stores awarded 250,386 shares and 252,173 shares of restricted stock during the 24 weeks ended September 9, 2006 and September 10, 2005, respectively. Shares awarded to employees vest in 20 percent increments over a

five-year service period. Awards granted to directors prior to May 10, 2006 vest 100 percent after three years and awards granted on or after May 10, 2006 vest in one-third increments over a three-year service period. Awards are subject to certain transfer restrictions and forfeiture prior to vesting. All shares fully vest upon a "Change in Control"



as defined by the Plan. Compensation expense, representing the fair value of the stock at the measurement date of the award, is recognized over the vesting period.

The following table summarizes restricted stock activity for the 24 weeks ended September 9, 2006:

|   | Shares   | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|---|----------|---|
|   | <hr/>    | <hr/>   |
| <b>Outstanding and nonvested at March 25, 2006</b>    | 436,998  | \$ 7.83   |
| Granted   | 250,386  | 13.71   |
| Vested  | (93,398) | 7.44  |
| Forfeited   | (39,882) | 10.10   |
|   | <hr/>    | <hr/>   |
| <b>Outstanding and nonvested at September 9, 2006</b> | 554,104  | \$ 10.39  |
|   | <hr/>    | <hr/>   |

The weighted average grant-date fair value of restricted shares granted during the 24 weeks ended September 9, 2006 and September 10, 2005 was \$13.71 and \$11.50, respectively. The total fair value of shares vested during the 24 weeks ended September 9, 2006 and September 10, 2005 was \$0.7 million and \$0.2 million, respectively.

Share-based compensation expense recognized and included in Selling, general and administrative expenses in the Consolidated Statements of Earnings and related tax benefits were as follows:

(In thousands)

|                  | 24 Weeks Ended       |                       |
|------------------|----------------------|-----------------------|
|                  | September 9,<br>2006 | September 10,<br>2005 |
|                  | <hr/>                | <hr/>                 |
| Stock options    | \$ 282               | \$ -                  |
| Restricted stock | 626                  | 366                   |
| Tax benefits     | (318)                | (128)                 |
|                  | <hr/>                | <hr/>                 |
|                  | \$ 590               | \$ 238                |
|                  | <hr/>                | <hr/>                 |

As of September 9, 2006, total unrecognized compensation cost related to nonvested share-based awards granted under the stock incentive plans was \$1.2 million for stock options and \$5.3 million for restricted stock. The remaining compensation costs not yet recognized are expected to be recognized over a weighted average period of 2.7 years for stock options and approximately 3.7 years for restricted stock.

## Note 8 Supplemental Cash Flow Information

Non-cash financing activities include the issuance of restricted stock to employees and directors of \$3.5 million and \$3.1 million for the year-to-date periods ended September 9, 2006 and September 10, 2005, respectively, of which \$0.2 million has been recognized as compensation expense in each year-to-date period.





**ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**  
**Executive Overview**

Spartan Stores is a leading regional grocery distributor and grocery retailer, operating principally in Michigan, Ohio and Indiana.

We currently operate two reportable business segments: Distribution and Retail. Our Distribution segment provides a full line of grocery, general merchandise, frozen and perishable items to over 350 independently owned grocery stores and our 87 corporate owned stores. Our Retail segment operates 68 retail supermarkets in Michigan under the banners *Family Fare Supermarkets*, *Glen's Markets* and *D&W Fresh Markets*, 19 deep-discount food and drug stores in Ohio and Michigan under the banner *The Pharm*, and six fuel centers under the banners *Family Fare Quick Stop* and *Glen's Quick Stop* which are typically located adjacent to one of our supermarkets. Sixteen of our supermarkets were acquired early in Fiscal 2007. Our retail supermarkets have a "neighborhood market" focus to distinguish them from supercenters and limited assortment stores. Our deep-discount food and drug stores offer a unique combination of full-service pharmacy, general merchandise products and basic food offerings.

Our sales and operating performance vary with seasonality. The first and fourth quarters are typically our lowest sales quarters and therefore operating results are generally lower during these two quarters. Additionally, these two quarters can be affected by the timing of the Easter holiday, which results in a strong sales week. All quarters are 12 weeks, except for our third quarter, which is 16 weeks and includes the Thanksgiving and Christmas holidays. Fiscal 2007 will contain 53 weeks, therefore, the fourth quarter of fiscal 2007 will consist of 13 weeks rather than 12 weeks. Many northern Michigan stores are dependent on tourism, and therefore, are most affected by seasons and weather patterns, including, but not limited to, the amount and timing of snowfall during the winter months and the range of temperature during the summer months.

On March 27, 2006, we acquired certain assets and assumed certain liabilities of sixteen operating and four non-operating supermarkets from D&W Food Centers, Inc. and D&W Associate Resources, LLC (together "D&W"), a privately held Grand Rapids, Michigan-based retail grocery operator with 20 retail stores located in West Michigan.

## Results of Operations

The following table sets forth items from our Consolidated Statements of Earnings as a percentage of net sales and the year-to-year percentage change in dollar amounts:

(Unaudited)

|  | Percentage of Net Sales |                |                |                | Percentage Change |                |
|--|-------------------------|----------------|----------------|----------------|-------------------|----------------|
|  | 12 Weeks Ended          |                | 24 Weeks Ended |                | 12 Weeks Ended    | 24 Weeks Ended |
|  | Sept. 9, 2006           | Sept. 10, 2005 | Sept. 9, 2006  | Sept. 10, 2005 | Sept. 9, 2006     | Sept. 9, 2006  |
| Net sales  | 100.0                   | 100.0          | 100.0          | 100.0          | 15.2              | 15.1           |
| Gross margin   | 20.0                    | 19.3           | 19.8           | 19.0           | 19.7              | 20.1           |
| Selling, general and administrative                      | 16.8                    | 16.7           | 17.1           | 17.1           | 15.9              | 15.9           |
| Provision for asset impairments and exit costs           | 0.0                     | 0.0            | 0.4            | 0.0            | 0.0               | *              |
| Operating earnings                                       | 3.2                     | 2.6            | 2.3            | 1.9            | 44.8              | 34.7           |
| Other income and expenses                                | 0.6                     | 0.4            | 0.6            | 0.4            | 81.3              | 73.0           |
| Earnings before income taxes and discontinued operations | 2.6                     | 2.2            | 1.7            | 1.5            | 38.6              | 25.7           |
| Income taxes   | 0.9                     | 0.7            | 0.6            | 0.5            | 48.9              | 33.1           |
| Earnings from continuing operations                      | 1.7                     | 1.5            | 1.1            | 1.0            | 33.7              | 22.1           |
| Loss from discontinued operations                        | (0.0)                   | (0.1)          | (0.0)          | (0.0)          | (47.0)            | (88.6)         |
| Net earnings   | 1.7                     | 1.4            | 1.1            | 1.0            | 36.2              | 26.5           |

\* Percentage change is not meaningful

**Net Sales** - Net sales for the quarter ended September 9, 2006 ("second quarter") increased \$73.8 million, or 15.2 percent, from \$485.5 million in the quarter ended September 10, 2005 ("prior year second quarter") to \$559.4 million. Net sales for the year-to-date period ended September 9, 2006 ("current year-to-date") increased \$142.5 million, or 15.1 percent, from \$944.9 million in the prior year-to-date period ended September 10, 2005 ("prior year-to-date") to \$1,087.4 million.

Net sales for the second quarter in our Distribution segment increased \$17.8 million, or 6.8 percent, from \$263.7 million in the prior year second quarter to \$281.5 million. Net sales for the current year-to-date period increased \$36.9 million, or 7.1 percent, from \$520.4 million in the prior year-to-date period to \$557.3 million. The sales increase was due to new distribution customer business of \$7.4 million and \$20.4 million for the second quarter and year-to-date period, respectively, and an increase in sales to existing customers of \$10.4 million and \$16.5 million for the second quarter and year-to-date period, respectively.

Net sales for the second quarter in our Retail segment increased \$56.0 million, or 25.3 percent, from \$221.9 million in the prior year second quarter to \$277.9 million. Net sales for the year-to-date period increased \$105.6 million, or 24.9 percent, from \$424.5 million in the prior year-to-date period to \$530.1 million. The sales increase was due primarily to incremental sales from the acquired D&W retail stores of \$46.1 million and \$89.5 million for the second quarter and year-to-date period, respectively, higher fuel center sales of \$7.7 million and \$13.9 million for the second quarter and year-to-date period, respectively, and comparable store sales growth. Comparable stores sales were favorably impacted by the closing of competitive conventional supermarkets in our markets. The second quarter and year-to-date sales increases were partially offset by lost sales of \$3.6 million and \$4.2 million, respectively, from two stores closed near the end of the first quarter as part of our store base rationalization effort.

Total retail comparable store sales increased 6.4 percent in the second quarter, including sales from six fuel centers, which contributed a positive 3.5 percentage points to the total. Total retail comparable store sales increased 5.3 percent in the current year-to-date period, while fuel center sales contributed a positive 3.3 percent to the total.

**Cost of Sales and Gross Margin** - Gross margin represents sales less cost of sales, which include purchase costs and promotional allowances. Vendor allowances that relate to our buying and merchandising activities consist primarily of promotional allowances, which are generally allowances on purchased quantities and, to a lesser extent, slotting allowances, which are billed to vendors for our merchandising costs, such as setting up warehouse infrastructure. Vendor allowances associated with product cost are recognized as a reduction in cost of sales when the product is sold. Lump sum payments received for multi-year contracts are amortized over the life of the contracts based on contractual terms.

Gross margin for the second quarter increased \$18.4 million, or 19.7 percent, from \$93.5 million in the prior year second quarter to \$112.0 million. As a percent of net sales, gross margin for the second quarter increased to 20.0 percent from 19.3 percent. Gross margin for the year-to-date period increased \$36.1 million, or 20.1 percent, from \$179.4 million in the prior year-to-date period to \$215.5 million. As a percent of net sales, gross margin for the year-to-date period increased to 19.8 percent from 19.0 percent. The gross margin rate improvement was primarily due to a larger concentration of higher margin retail sales and operational synergies resulting from our retail acquisition.

**Selling, General and Administrative Expenses** - Selling, general and administrative ("SG&A") expenses consist primarily of salaries and wages, employee benefits, warehousing costs, store occupancy costs, utilities, equipment rental, depreciation and other administrative costs.

SG&A expenses for the second quarter increased \$12.9 million, or 15.9 percent, from \$81.3 million in the prior year second quarter to \$94.3 million. As a percent of net sales, SG&A expenses were 16.8 percent for the current quarter compared to 16.7 percent in the prior year second quarter. SG&A expenses for the year-to-date period increased \$25.6 million, or 15.9 percent, from \$160.8 million in the prior year-to-date period to \$186.4 million. As a percent of net sales, SG&A expenses were 17.1 percent for each year-to-date period. The increase in SG&A was primarily due to incremental expenses associated with the acquired stores of \$12.4 million and \$24.8 million for the second quarter and year-to-date period, respectively. The year-to-date increase includes \$1.1 million of training and other start-up related costs related to the D&W acquisition in the first quarter. Incremental costs of operating additional fuel centers and higher utilities, Distribution fuel costs and bank card fees contributed \$1.1 million and \$2.3 million to the second quarter and year-to-date period increases in SG&A expenses, respectively. These increases were partially offset by positive loss trends in health care, workers' compensation and general liability insurance resulting in a decrease in SG&A of \$1.3 million and \$.6 million for the second quarter and year-to-date period, respectively.

**Provision for Asset Impairments and Exit Costs** - In the first quarter, the Retail segment recognized charges of \$4.5 million for asset impairment and lease and related ancillary costs related to the closure of two *Family Fare Supermarkets* stores and moving the central bakery operation into individual retail stores. The store base rationalization and associated charge was incurred due to the proximity of acquired stores to our existing store base. This limited reduction of our store network was based on an evaluation of stores that were best positioned to provide customers with the highest quality overall shopping experience. The central bakery decision was based on the desire to move the production of bakery products closer to the consumer, and the economics of the central bakery operation. Although the charge reduced first-quarter earnings performance, we expect the restructuring decision to improve ongoing earnings trends.

**Interest Expense** - Interest expense for the second quarter increased \$1.2 million, or 67.4 percent, from \$1.8 million in the prior year second quarter to \$3.0 million. Interest expense for the year-to-date period increased \$2.3 million, or 64.5 percent, from \$3.5 million in the prior year-to-date period to \$5.8 million. Interest expense increased by \$1.0 million and \$1.4 million for the second quarter and year-to-date period, respectively, due to an increase in total average borrowings as a result of the D&W acquisition. Interest expense increased \$0.2 million and \$0.9 million for the second quarter and year-to-date period, respectively, due to multiple rate increases by the Federal Reserve.

Total average borrowings increased \$33.8 million from \$86.2 million in the prior year to \$120.0 million.



## Discontinued Operations

Our former convenience distribution operations, insurance operations and certain of our retail, grocery distribution and real estate operations have been recorded as discontinued operations. Results of the discontinued operations are excluded from the accompanying notes to the condensed consolidated financial statements for all periods presented, unless otherwise noted. Discontinued operations activity was not significant in the second quarter and year-to-date periods in fiscal 2007 and fiscal 2006.

## Liquidity and Capital Resources

The following table summarizes our consolidated statements of cash flows for the year-to-date and prior year-to-date periods:

(In thousands)

|  | September 9,<br>2006 | September 10,<br>2005 |
|--|----------------------|-----------------------|
| Net cash provided by operating activities              | \$ 24,195            | \$ 22,375             |
| Net cash used in investing activities                  | (59,861)             | (8,757)               |
| Net cash provided by (used in) financing activities    | 37,914               | (12,442)              |
| Net cash provided by (used in) discontinued operations | 318                  | (2,562)               |
| Net increase (decrease) in cash and cash equivalents   | 2,566                | (1,386)               |
| Cash and cash equivalents at beginning of period       | 7,655                | 14,880                |
| Cash and cash equivalents at end of period             | \$ 10,221            | \$ 13,494             |

Net cash provided by operating activities increased from the prior year-to-date period primarily due to earnings from continuing operations.

As of September 9, 2006, we have available a Federal income tax net operating loss carryforward of approximately \$14.1 million. As a result, no regular Federal income taxes have been paid in Fiscal 2007; however, we do anticipate paying approximately \$0.5 million in Alternative Minimum Tax in Fiscal 2007. No regular Federal income taxes were paid in Fiscal 2006. Payments of Alternative Minimum Tax in Fiscal 2006 totaled \$0.2 million.

Net cash used in investing activities increased during the current fiscal year primarily due to the D&W acquisition and increased capital expenditure activity. We paid a total cash purchase price of \$47.9 million for the acquisition, which is reflected in investing activities. Excluding the acquisition, our Distribution and Retail segments utilized 23.8% and 76.2%, respectively, of our capital expenditure dollars. Expenditures were used for new equipment, software and store remodels and refurbishments. Under the terms of our credit facility, should our available borrowings fall below certain levels, our capital expenditures would be restricted each fiscal year. We expect capital expenditures to range from \$30.0 million to \$33.0 million for fiscal 2007, which would be allowed even if the restriction applied.

Net cash provided by (used in) financing activities includes cash paid and received from our long-term borrowings, proceeds from the issuance of common stock and dividends paid. The increase in cash from financing activities was due to borrowings on our revolving credit facility that were used to finance the D&W acquisition and common stock proceeds, partially offset by dividend payments of \$1.1 million in the first quarter. The second

quarterly dividend of \$1.1 million was paid on September 15, 2006. In the fiscal 2006 fourth quarter, as permitted by amendment to our credit facility, our board of directors approved a change to our dividend policy and we began paying a quarterly cash dividend of \$0.05 per common share. Although we expect to continue to pay a quarterly cash dividend, adoption of a dividend policy does not commit the board of directors to declare future dividends. Each future dividend will be considered and declared by the board of directors in its discretion. Whether the board of directors continues to declare dividends depends on a number of factors, including our future financial condition and profitability and compliance with the terms of our credit facilities. Our current maturities of long-term debt at September 9, 2006 are \$5.4 million. Our ability to borrow additional funds is governed by the terms of our credit facilities.

Net cash provided by (used in) discontinued operations contains the net cash flows of our discontinued operations and consists primarily of the payment of store exit cost reserves, insurance run-off claims and other liabilities and proceeds from the sale of assets. Year-to-date fiscal 2007 proceeds on the sale of assets were \$1.7 million resulting in a gain of \$0.2 million. We expect the cash usage of our discontinued operations will be approximately \$4.0 million to \$5.0 million in fiscal 2007.

Our principal sources of liquidity are cash flows generated from operations and our amended \$225.0 million senior secured revolving credit facility. The credit facility matures December 2010, and is secured by substantially all of our assets. As of September 9, 2006, we had outstanding borrowings of \$92.9 million, available borrowings of \$91.1 million and maximum availability of \$101.1 million, which exceeds the minimum excess availability levels, as defined in the credit agreement. On March 27, 2006, proceeds from our senior secured revolving credit facility of \$47.9 million were used to acquire certain assets of D&W. We believe that cash generated from operating activities and available borrowings under the credit facility are sufficient to support current operations.

Our current ratio increased to 1.16:1.00 at September 9, 2006 from 1.14:1.00 at March 25, 2006 and our investment in working capital was \$26.7 million at September 9, 2006 versus \$20.7 million at March 25, 2006. Our debt to total capital ratio at September 9, 2006 was .44:1.00 versus .31:1.00 at March 25, 2006. The change in these ratios was primarily due to funds drawn under the credit facility and capital lease obligations assumed related to the D&W acquisition.

For information on contractual obligations, see our Annual Report on Form 10-K for the fiscal year ended March 25, 2006. At September 9, 2006, there have been no material changes to our significant contractual obligations outside the ordinary course of business, except for the assumption of lease obligations in the D&W acquisition. As of September 9, 2006, our obligations under the leases assumed in the D&W acquisition are as follows:

| (In thousands)   | Payment Due by Period |                  |                  |                  |                   |
|--|-----------------------|------------------|------------------|------------------|-------------------|
|  | Total                 | Less than 1 year | 1-3 years        | 3-5 years        | More than 5 years |
| Operating leases   | \$ 37,085             | \$ 4,549         | \$ 8,110         | \$ 6,776         | \$ 17,650         |
| Capital leases   | 38,570                | 2,645            | 5,387            | 5,629            | 24,909            |
| Lease and ancillary costs of closed stores, including imputed interest | 22,339                | 2,875            | 5,874            | 3,969            | 9,621             |
| <b>Total</b>   | <b>\$ 97,994</b>      | <b>\$ 10,069</b> | <b>\$ 19,371</b> | <b>\$ 16,374</b> | <b>\$ 52,180</b>  |

### Off-Balance Sheet Arrangements

We had letters of credit of \$10.0 million outstanding and unused at September 9, 2006. The letters of credit are maintained primarily to support payment or deposit obligations. We pay a commission of 3% on the face amount of the letters of credit.

### New Accounting Standards

Effective March 26, 2006, we adopted the provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment", using the modified-prospective transition method. SFAS No. 123(R) addresses the accounting for share-based payments to employees, including grants of employee stock options and other forms of share-based compensation. Prior to adoption of SFAS No. 123(R), we accounted for share-based awards under the

recognition and measurement provisions of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations, as permitted by SFAS No. 123, "Accounting for Stock-Based Compensation." Under this method, no stock-based compensation cost was reflected in the Consolidated Statements of Earnings for stock options as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. Adoption of SFAS No. 123(R) resulted in additional compensation expense of \$0.1 million and \$0.2 million net of tax for the second quarter and

year-to-date period, respectively. We expect a similar amount of incremental expense in future periods during Fiscal 2007. Basic earnings per share decreased \$0.01 for the year-to-date period as a result of adopting SFAS 123(R). Basic earnings per share for the second quarter and dilutive earnings per share for the second quarter and year-to-date period did not change as a result of adopting SFAS 123(R). As of September 9, 2006, total unrecognized compensation cost related to nonvested share-based awards granted under the stock incentive plans was \$1.2 million for stock options and \$5.3 million for restricted stock. The remaining compensation costs not yet recognized are expected to be recognized over a weighted average period of 2.7 years for stock options and approximately 3.7 years for restricted stock.

The fair value of each stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model. Prior to adoption of SFAS No. 123(R), under the provisions of SFAS No. 123, expected volatility was determined based upon historical volatility of Spartan Stores common stock and the historical volatilities of guideline companies for the period of time that Spartan Stores was not publicly traded. The expected term of options granted was based upon expectations of future exercise behavior derived from vesting and contractual terms. Upon adoption of SFAS No. 123(R), and under the provisions of this statement, expected volatility was determined based upon a combination of applicable historical volatility of Spartan Stores common stock and the expected volatilities of guideline companies that are comparable to Spartan Stores in most significant respects to reflect management's best estimate of Spartan Stores' future volatility over the option term. The expected term of options granted is determined using the "simplified method" as described in SEC Staff Accounting Bulletin No. 107 that uses the following formula:  $((\text{vesting term} + \text{original contract term})/2)$ . Expected dividend yield is based on historical dividend payments under the current dividend policy.

In June 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with SFAS No. 109, "Accounting for Income Taxes", and prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Further, FIN 48 provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective at the beginning of our fiscal year 2008. We are currently evaluating the impact of FIN 48 on our financial statements.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements". SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS No. 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, and states that a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. SFAS No. 157 will become effective for at the beginning of our fiscal year 2009. We are currently evaluating the impact, if any, that SFAS No. 157 will have on our financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements Nos. 87, 88, 106 and 132(R)", effective for public companies for fiscal years ending after December 15, 2006. SFAS No. 158 requires employers that sponsor a defined benefit postretirement plan to recognize the overfunded or underfunded status of defined benefit postretirement plans, including pension plans, in their balance sheets and to recognize changes in funded status through comprehensive income in the year in which the changes occur. This aspect of SFAS No. 158 is effective for our current fiscal year ending March 31, 2007. The Statement also requires that employers measure plan assets and obligations as of the date of their year-end financial statements beginning with our fiscal year ending March 28, 2009. We are currently evaluating the impact of the Statement on our financial statements.

### **Critical Accounting Policies**

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts. On an ongoing basis, we evaluate our estimates, including those related to bad debts, inventories, intangible assets, assets held for sale, long-lived assets, income taxes, self-insurance reserves, exit costs, retirement benefits, stock-based compensation and contingencies and litigation. We base our estimates on historical experience and on various other assumptions and factors that we believe to be reasonable

under the circumstances. Based on our ongoing review, we make adjustments we consider appropriate under the facts and circumstances. We have discussed the development, selection and disclosure of these estimates with the Audit Committee. The accompanying condensed consolidated financial statements are prepared using the same critical accounting policies discussed in our Annual Report on Form 10-K for the fiscal year ended March 25, 2006.

**ITEM 3. Quantitative and Qualitative Disclosure About Market Risk**

There have been no material changes in market risk of Spartan Stores from the information provided under Part II, Item 7A, "Quantitative and Qualitative Disclosure About Market Risk", of the Company's Annual Report on Form 10-K for the fiscal year ended March 25, 2006.

**ITEM 4. Controls and Procedures**

An evaluation of the effectiveness of the design and operation of Spartan Stores' disclosure controls and procedures (as currently defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) was performed as of September 9, 2006 (the "Evaluation Date"). This evaluation was performed under the supervision and with the participation of Spartan Stores' management, including its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). As of the Evaluation Date, Spartan Stores' management, including the CEO and CFO, concluded that Spartan Stores' disclosure controls and procedures were effectively designed and operated to cause material information relating to Spartan Stores (including its consolidated subsidiaries) required to be included in Spartan Stores' periodic filings with the Securities and Exchange Commission to be accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. During the last fiscal quarter there was no change in Spartan Stores' internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Spartan Stores' internal control over financial reporting.

**PART II**  
**OTHER INFORMATION**

**ITEM 1A. Risk Factors**

In addition to the other information set forth in this report, investors should carefully consider the factors discussed under Part I, Item 1A, "Risk Factors", of the Company's Annual Report on Form 10-K for the fiscal year ended March 25, 2006. There have been no material changes to such risk factors.

**ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The following table provides information regarding the Company's purchases of its own common stock during the second quarter. The Company has no public stock repurchase plans or programs. All transactions reported are with associates under stock compensation plans. These include: (1) shares of Spartan Stores, Inc. stock delivered in satisfaction of the exercise price and/or tax withholding obligations by holders of employee stock options who exercised options, and (2) shares withheld to satisfy tax withholding obligations that occur upon the vesting of the restricted shares. Under the Company's associate stock compensation plans, the value of the shares delivered or withheld is the average of the high and low price of the Company's common stock on the date the relevant transaction occurs.

**Spartan Stores, Inc. Purchases of Equity Securities**

| Period   | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price Paid<br>per Share |
|--|---|------------------------------------|
| Period 1 (June 18 - July 15, 2006)               |   |                                    |
| Employee Transactions                            | -   | -                                  |
| Period 2 (July 16 - August 12, 2006)             |   |                                    |
| Employee Transactions                            | 51,163                                    | \$ 15.09                           |
| Period 3 (August 13 - September 9, 2006)         |   |                                    |
| Employee Transactions                            | 228                                       | \$ 18.05                           |
| Total for Second Quarter ended September 9, 2006 | 51,391                                    | \$ 15.10                           |



**ITEM 4. Submission of Matters to a Vote of Security Holders**

Spartan Stores held its 2006 annual meeting on August 16, 2006. At the meeting, the following matters were submitted to a vote of the shareholders:

1. election of three directors; and
2. ratification of the selection of Deloitte & Touche LLP as Spartan Stores' independent auditors for fiscal 2007.

The following three persons were duly elected at the meeting:

|                      | <u>Term Expiring</u> | <u>Votes For</u> | <u>Votes Withheld</u> |
|----------------------|----------------------|------------------|-----------------------|
| M. Shân Atkins       | 2009                 | 17,625,541       | 166,503               |
| Dr. Frank M. Gambino | 2009                 | 17,621,719       | 170,325               |
| Timothy J. O'Donovan | 2009                 | 17,602,058       | 189,986               |

The following five persons continue to serve as directors of Spartan Stores: Craig C. Sturken and Frederick J. Morgenthall, II are currently serving terms that will expire at Spartan Stores' 2007 annual meeting of shareholders and Elizabeth A. Nickels, Kenneth T. Stevens and James F. Wright are currently serving terms that will expire at Spartan Stores' 2008 annual meeting of shareholders.

The shareholders voted on a proposal to ratify the selection of Deloitte & Touche LLP as Spartan Stores' independent auditors for fiscal year 2007. With respect to this proposal, shares were voted as follows:

| <u>Proposal</u>   | <u>For</u> | <u>Against</u> | <u>Abstain</u> | <u>Broker Non-Votes</u> |
|---|------------|----------------|----------------|-------------------------|
| Proposal to ratify the selection of Deloitte & Touche LLP as Spartan Stores' independent auditors for fiscal year 2007. | 17,580,132 | 151,000        | 60,912         | 0                       |

**ITEM 6. Exhibits**

The following documents are filed as exhibits to this Quarterly Report on Form 10-Q:

| <u>Exhibit Number</u> | <u>Document</u>  |
|-----------------------|--|
| 2.1                   | Asset Purchase Agreement dated December 17, 2005, by and among Family Fare LLC, Prevo's Family Markets, Inc., D&W Food Centers, Inc., and D&W Associate Resources, LLC. Previously filed as an exhibit to Spartan Stores' Current Report on Form 8-K, filed December 22, 2005. Here incorporated by reference.             |
| 2.2                   | First Amendment to Asset Purchase Agreement dated March 24, 2006 by and among Family Fare LLC, Prevo's Family Markets, Inc., D&W Food Centers, Inc., and D&W Associate Resources, LLC. Previously filed as an exhibit to Spartan Stores' Current Report on Form 8-K, filed March 30, 2006. Here incorporated by reference. |
| 3.1                   | Amended and Restated Articles of Incorporation of Spartan Stores, Inc. Previously filed as an exhibit to Spartan Stores' Quarterly Report on Form 10-Q for the quarter ended September 10, 2005. Here incorporated by reference.   |
| 3.2                   | Amended and Restated Bylaws of Spartan Stores, Inc. Previously filed as an exhibit to Spartan Stores' Quarterly Report on Form 10-Q for the quarter ended September 13, 2003. Here incorporated by reference.  |
| 10.1                  | Director Compensation Plan.  |
| 31.1                  | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 31.2                  | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  |
| 32.1                  | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |

**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.

SPARTAN STORES, INC.  
(Registrant)

Date: October 12, 2006

By

/s/ David M. Staples

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David M. Staples  
Executive Vice President and Chief Financial  
Officer  
(Principal Financial Officer and duly authorized  
signatory for Registrant)

**EXHIBIT INDEX**

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