

Sprouts Farmers Market, Inc.  
Form 10-Q  
November 06, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, D.C. 20549**  
**FORM 10-Q**

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

For the quarterly period ended September 28, 2014

Commission File Number: 001-36029

**Sprouts Farmers Market, Inc.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of

incorporation or organization)

32-0331600  
(I.R.S. Employer

Identification No.)

11811 N. Tatum Boulevard, Suite 2400

Phoenix, Arizona 85028

(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

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for such shorter period that the registrant was required to submit and post such files). Yes ☒ No ☐

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

Large accelerated filer ☐ Accelerated filer ☐

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

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

As of November 4, 2014, there were outstanding 150,951,436 shares of the registrant's common stock, \$0.001 par value per share.

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**SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES**  
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**FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 28, 2014**  
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### **Explanatory Note**

*On July 29, 2013, Sprouts Farmers Markets, LLC, a Delaware limited liability company, converted into Sprouts Farmers Market, Inc., a Delaware corporation, as described under Management's Discussion and Analysis of Financial Condition and Results of Operations Factors Affecting Comparability of Results of Operations Corporate Conversion. As used in this Quarterly Report on Form 10-Q, unless the context otherwise requires, references to the Company, Sprouts, we, us and our refer to Sprouts Farmers Markets, LLC and, after the corporate conversion, to Sprouts Farmers Market, Inc. and, where appropriate, its subsidiaries. In the corporate conversion, each unit of Sprouts Farmers Markets, LLC was converted into 11 shares of common stock of Sprouts Farmers Market, Inc., and each option to purchase units of Sprouts Farmers Markets, LLC was converted into an option to purchase 11 shares of common stock of Sprouts Farmers Market, Inc. For the convenience of the reader, except as the context otherwise requires, all information included in this Quarterly Report on Form 10-Q is presented giving effect to the corporate conversion.*

*On July 31, 2013, the Company's Registration Statement on Form S-1 (Reg. No. 333-188493) and the Company's Registration Statement on Form 8-A became effective, and the Company became subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (referred to as the Exchange Act).*

### **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 Exchange Act, including, but not limited to, statements regarding our expectations, beliefs, intentions, strategies, future operations, future financial position, future revenue, projected expenses, and plans and objectives of management. In some cases, you can identify forward-looking statements by terms such as anticipate, believe, estimate, expect, intend, may, might, plan, project, will, would, should, could, can, predict, potential, continue, objective, or the negative of these terms, and similar expressions intended to identify forward-looking statements. However, not all forward-looking statements contain these identifying words. These forward-looking statements reflect our current views about future events and involve known risks, uncertainties, and other factors that may cause our actual results, levels of activity, performance, or achievement to be materially different from those expressed or implied by the forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the section titled Risk Factors included in this Quarterly Report on Form 10-Q, our Annual Report on Form 10-K for the fiscal year ended December 29, 2013, 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.*

**Table of Contents****PART I FINANCIAL INFORMATION****Item 1. Financial Statements****SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(UNAUDITED)****(IN THOUSANDS, EXCEPT SHARE AND PER SHARE AMOUNTS)**

|                                                                                                                                                                                   | September 28,<br>2014 | December 29,<br>2013 |
|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------|----------------------|
| <b>ASSETS</b>                                                                                                                                                                     |                       |                      |
| Current assets:                                                                                                                                                                   |                       |                      |
| Cash and cash equivalents                                                                                                                                                         | \$ 118,447            | \$ 77,652            |
| Accounts receivable, net                                                                                                                                                          | 14,077                | 9,524                |
| Inventories                                                                                                                                                                       | 140,104               | 118,256              |
| Prepaid expenses and other current assets                                                                                                                                         | 6,406                 | 8,049                |
| Deferred income tax asset                                                                                                                                                         | 8,775                 | 18,146               |
| Total current assets                                                                                                                                                              | 287,809               | 231,627              |
| Property and equipment, net of accumulated depreciation                                                                                                                           | 416,916               | 348,830              |
| Intangible assets, net of accumulated amortization                                                                                                                                | 194,499               | 195,467              |
| Goodwill                                                                                                                                                                          | 368,078               | 368,078              |
| Other assets                                                                                                                                                                      | 18,210                | 13,135               |
| Deferred income tax asset                                                                                                                                                         | 11,571                | 15,267               |
| Total assets                                                                                                                                                                      | \$ 1,297,083          | \$ 1,172,404         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                                                                                                                       |                       |                      |
| Current liabilities:                                                                                                                                                              |                       |                      |
| Accounts payable                                                                                                                                                                  | \$ 122,752            | \$ 111,159           |
| Accrued salaries and benefits                                                                                                                                                     | 25,661                | 22,287               |
| Income taxes payable                                                                                                                                                              | 4,133                 |                      |
| Other accrued liabilities                                                                                                                                                         | 34,640                | 32,958               |
| Current portion of capital and financing lease obligations                                                                                                                        | 3,995                 | 3,395                |
| Current portion of long-term debt                                                                                                                                                 | 6,008                 | 5,822                |
| Total current liabilities                                                                                                                                                         | 197,189               | 175,621              |
| Long-term capital and financing lease obligations                                                                                                                                 | 122,654               | 116,177              |
| Long-term debt                                                                                                                                                                    | 251,848               | 305,418              |
| Other long-term liabilities                                                                                                                                                       | 74,832                | 61,417               |
| Total liabilities                                                                                                                                                                 | 646,523               | 658,633              |
| Commitments and contingencies (Note 10)                                                                                                                                           |                       |                      |
| Stockholders' equity:                                                                                                                                                             |                       |                      |
| Undesignated preferred stock; \$0.001 par value; 10,000,000 shares authorized, no shares issued and outstanding                                                                   |                       |                      |
| Common stock, \$0.001 par value; 200,000,000 shares authorized, 150,643,564 and 147,616,560 shares issued and outstanding, September 28, 2014 and December 29, 2013, respectively | 150                   | 147                  |

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|                                            |              |              |
|--------------------------------------------|--------------|--------------|
| Additional paid-in capital                 | 525,964      | 479,127      |
| Retained earnings                          | 124,446      | 34,497       |
| Total stockholders' equity                 | 650,560      | 513,771      |
| Total liabilities and stockholders' equity | \$ 1,297,083 | \$ 1,172,404 |

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

**Table of Contents****SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF OPERATIONS****(UNAUDITED)****(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)**

|                                              | <b>Thirteen Weeks Ended</b>   |                               | <b>Thirty-Nine Weeks Ended</b> |                               |
|----------------------------------------------|-------------------------------|-------------------------------|--------------------------------|-------------------------------|
|                                              | <b>September 28,<br/>2014</b> | <b>September 29,<br/>2013</b> | <b>September 28,<br/>2014</b>  | <b>September 29,<br/>2013</b> |
| Net sales                                    | \$ 766,415                    | \$ 633,614                    | \$ 2,232,831                   | \$ 1,829,675                  |
| Cost of sales, buying and occupancy          | 540,367                       | 443,509                       | 1,558,876                      | 1,278,623                     |
| Gross profit                                 | 226,048                       | 190,105                       | 673,955                        | 551,052                       |
| Direct store expenses                        | 148,633                       | 129,418                       | 430,019                        | 367,064                       |
| Selling, general and administrative expenses | 24,015                        | 22,807                        | 69,594                         | 60,259                        |
| Store pre-opening costs                      | 3,684                         | 1,237                         | 7,051                          | 5,254                         |
| Store closure and exit costs                 | 60                            | (38)                          | 393                            | 1,670                         |
| Income from operations                       | 49,656                        | 36,681                        | 166,898                        | 116,805                       |
| Interest expense                             | (6,157)                       | (8,790)                       | (19,144)                       | (30,346)                      |
| Other income                                 | 281                           | 203                           | 477                            | 447                           |
| Loss on extinguishment of debt               | (1,138)                       | (9,507)                       | (1,138)                        | (17,682)                      |
| Income before income taxes                   | 42,642                        | 18,587                        | 147,093                        | 69,224                        |
| Income tax provision                         | (16,577)                      | (7,126)                       | (57,144)                       | (27,178)                      |
| Net income                                   | \$ 26,065                     | \$ 11,461                     | \$ 89,949                      | \$ 42,046                     |
| Net income per share:                        |                               |                               |                                |                               |
| Basic                                        | \$ 0.17                       | \$ 0.08                       | \$ 0.60                        | \$ 0.32                       |
| Diluted                                      | \$ 0.17                       | \$ 0.08                       | \$ 0.58                        | \$ 0.31                       |
| Weighted average shares outstanding:         |                               |                               |                                |                               |
| Basic                                        | 150,241                       | 139,687                       | 149,227                        | 130,538                       |
| Diluted                                      | 154,306                       | 144,710                       | 153,879                        | 134,529                       |

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

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**SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

**(UNAUDITED)**

**(IN THOUSANDS, EXCEPT SHARE AMOUNTS)**

|                                                            | Shares      | Common<br>Stock | Additional<br>Paid In<br>Capital | (Accumulated<br>Deficit) /<br>Retained<br>Earnings | Total<br>Stockholders<br>Equity |
|------------------------------------------------------------|-------------|-----------------|----------------------------------|----------------------------------------------------|---------------------------------|
| <b>Balances at December 30, 2012</b>                       | 125,956,721 | \$ 126          | \$ 395,480                       | \$ (8,851)                                         | \$ 386,755                      |
| Net income                                                 |             |                 |                                  | 51,326                                             | 51,326                          |
| Issuance of shares under option plans                      | 1,194,999   | 1               | 3,820                            |                                                    | 3,821                           |
| Issuance of shares in IPO, net of issuance costs           | 20,477,215  | 20              | 344,304                          |                                                    | 344,324                         |
| Repurchase of shares                                       | (12,375)    |                 | (113)                            |                                                    | (113)                           |
| Dividend paid to stockholders                              |             |                 | (274,051)                        | (7,978)                                            | (282,029)                       |
| Antidilution payments made to optionholders                |             |                 | (13,892)                         |                                                    | (13,892)                        |
| Excess income tax benefit for exercise of options          |             |                 | 13,424                           |                                                    | 13,424                          |
| Tax benefit of antidilution payments made to optionholders |             |                 | 4,402                            |                                                    | 4,402                           |
| Tax effect of forfeiture of vested options in equity       |             |                 | (27)                             |                                                    | (27)                            |
| Equity-based compensation                                  |             |                 | 5,780                            |                                                    | 5,780                           |
| <b>Balances at December 29, 2013</b>                       | 147,616,560 | \$ 147          | \$ 479,127                       | \$ 34,497                                          | \$ 513,771                      |
| Net income                                                 |             |                 |                                  | 89,949                                             | 89,949                          |
| Issuance of shares under option plans                      | 3,027,004   | 3               | 7,602                            |                                                    | 7,605                           |
| Excess income tax benefit for exercise of options          |             |                 | 35,041                           |                                                    | 35,041                          |
| Equity-based compensation                                  |             |                 | 4,194                            |                                                    | 4,194                           |
| <b>Balances at September 28, 2014</b>                      | 150,643,564 | \$ 150          | \$ 525,964                       | \$ 124,446                                         | \$ 650,560                      |

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

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

|                                                                                            | <b>Thirty-Nine Weeks Ended</b> |                               |
|--------------------------------------------------------------------------------------------|--------------------------------|-------------------------------|
|                                                                                            | <b>September 28,<br/>2014</b>  | <b>September 29,<br/>2013</b> |
| <b>Cash flows from operating activities</b>                                                |                                |                               |
| Net income                                                                                 | \$ 89,949                      | \$ 42,046                     |
| Adjustments to reconcile net income to net cash provided by operating activities:          |                                |                               |
| Depreciation and amortization expense                                                      | 40,586                         | 34,860                        |
| Accretion of asset retirement obligation and closed store reserve                          | 755                            | 84                            |
| Amortization of financing fees and debt issuance costs                                     | 1,152                          | 2,041                         |
| Loss on disposal of property and equipment                                                 | 1,038                          | 437                           |
| Gain on sale of intangible assets                                                          |                                | (19)                          |
| Equity-based compensation                                                                  | 4,194                          | 4,285                         |
| Non-cash loss on extinguishment of debt                                                    | 1,138                          | 17,474                        |
| Deferred income taxes                                                                      | 13,067                         | 20,070                        |
| Changes in operating assets and liabilities:                                               |                                |                               |
| Accounts receivable                                                                        | (4,654)                        | (721)                         |
| Inventories                                                                                | (21,848)                       | (16,383)                      |
| Prepaid expenses and other current assets                                                  | 1,617                          | (9,752)                       |
| Other assets                                                                               | (5,474)                        | (3,875)                       |
| Accounts payable                                                                           | 7,094                          | 39,808                        |
| Accrued salaries and benefits                                                              | 3,374                          | (469)                         |
| Other accrued liabilities and income taxes payable                                         | 5,814                          | (1,359)                       |
| Other long-term liabilities                                                                | 13,499                         | 9,777                         |
| Net cash provided by operating activities                                                  | 151,301                        | 138,304                       |
| <b>Cash flows from investing activities</b>                                                |                                |                               |
| Purchases of property and equipment                                                        | (96,099)                       | (74,777)                      |
| Proceeds from sale of intangible assets                                                    |                                | 172                           |
| Proceeds from sale of property and equipment                                               | 232                            | 2                             |
| Net cash used in investing activities                                                      | (95,867)                       | (74,603)                      |
| <b>Cash flows from financing activities</b>                                                |                                |                               |
| Borrowing on term loan, net of financing costs                                             |                                | 688,127                       |
| Payments on term loan                                                                      | (55,250)                       | (745,100)                     |
| Payments on senior subordinated notes                                                      |                                | (35,000)                      |
| Payments on capital lease obligations                                                      | (426)                          | (335)                         |
| Payments on financing lease obligations                                                    | (2,186)                        | (2,104)                       |
| Payments of deferred financing costs                                                       |                                | (1,370)                       |
| Payments of IPO costs                                                                      |                                | (4,212)                       |
| Cash from landlord related to financing lease obligations                                  | 577                            | 4,057                         |
| Payments to stockholders and option holders                                                |                                | (295,921)                     |
| Repurchase of shares                                                                       |                                | (113)                         |
| Excess tax benefit for exercise of stock options and antidilution payment to optionholders | 35,041                         | 4,402                         |
| Proceeds from the exercise of stock options                                                | 7,605                          | 75                            |

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|                                                                               |            |           |
|-------------------------------------------------------------------------------|------------|-----------|
| Proceeds from the issuance of shares                                          |            | 348,317   |
| Net cash used in financing activities                                         | (14,639)   | (39,177)  |
| Net increase in cash and cash equivalents                                     | 40,795     | 24,524    |
| Cash and cash equivalents at beginning of the period                          | 77,652     | 67,211    |
| Cash and cash equivalents at the end of the period                            | \$ 118,447 | \$ 91,735 |
| <b>Supplemental disclosure of cash flow information</b>                       |            |           |
| Cash paid for interest                                                        | \$ 18,164  | \$ 31,529 |
| Cash paid for income taxes                                                    | 3,982      | 1,276     |
| <b>Supplemental disclosure of non-cash investing and financing activities</b> |            |           |
| Property and equipment in accounts payable                                    | \$ 12,156  | \$ 6,332  |
| Property acquired through capital and financing lease obligations             | 9,113      | 10,986    |

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

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**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 that includes fresh produce, bulk foods, vitamins and supplements, grocery, meat and seafood, bakery, dairy, frozen foods, body care and natural household items catering to consumers' growing interest in eating and living healthier. The Company is used to refer collectively to Sprouts Farmers Market, Inc. and 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 29, 2013 included in the Company's Annual Report on Form 10-K, filed on February 27, 2014.

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. Fiscal years 2014 and 2013 are 52-week years. The Company reports its results of operations on a 13-week quarter, except for 53-week fiscal years.

The Company has revised its Statement of Cash Flows for the thirty-nine weeks ended September 29, 2013, to present cash inflows related to excess tax benefits from antidilution payments made to optionholders as cash flows from financing activities. This revision did not have a material impact on previously reported consolidated cash flows. Additionally, for the thirty-nine weeks ended September 28, 2014, and for the comparative period, the Company has offset the changes in balance sheet line items related to excess tax benefit with the excess tax benefit.

On August 6, 2013, the Company completed its initial public offering (IPO) of 21,275,000 shares of common stock at a price of \$18.00 per share. The Company sold 20,477,215 shares of common stock, and certain stockholders sold the remaining 797,785 shares. The Company received net proceeds from the IPO of \$344.1 million, after deducting underwriting discounts and offering expenses. See Note 11, Stockholders Equity for more information.

The Company has one reportable and one operating segment.

The Company's business is subject to modest seasonality. Average weekly sales fluctuate throughout the year and are typically highest in the first half of the fiscal year. Produce, which contributed 26% of the Company's net sales for the thirty-nine weeks ended September 28, 2014, is generally more available in the first six months of the fiscal year due to the timing of peak growing seasons.

All dollar amounts are in thousands, unless otherwise noted.

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**SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED) continued**

**2. Recently Issued Accounting Pronouncements**

In February 2013, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) No. 2013-04, Obligations Resulting from Joint and Several Liability Arrangements for Which the Total Amount of the Obligation Is Fixed at the Reporting Date (a consensus of the FASB Emerging Issues Task Force), which amends Accounting Standards Codification ( ASC ) 405, Liabilities. The amendments provide guidance on the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements, including debt arrangements, other contractual obligations, and settled litigation and judicial rulings, for which the total amount of the obligation is fixed at the reporting date. The amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013 and should be applied retrospectively. The provisions were effective from the Company's first quarter of 2014. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, which amends ASC 740, Income Taxes. ASU No. 2013-11 requires that unrecognized tax benefits be classified as an offset to deferred tax assets to the extent of any net operating loss carryforwards, similar tax loss carryforwards, or tax credit carryforwards are available at the reporting date in the applicable tax jurisdiction to settle any additional income taxes that would result from the disallowance of a tax position. An exception would apply if the tax law of the tax jurisdiction does not require the Company to use, and it does not intend to use, the deferred tax asset for such purpose. This guidance is effective for reporting periods beginning after December 15, 2013. The provisions were effective from the Company's first quarter of 2014. The adoption of this guidance did not have a material effect on the Company's consolidated financial statements.

In April 2014, the FASB issued ASU No. 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity. ASU No. 2014-08 amends previous guidance related to the criteria for reporting a disposal as a discontinued operation by elevating the threshold for qualification for discontinued operations treatment to a disposal that represents a strategic shift that has a major effect on an organization's operations or financial results. This guidance also requires expanded disclosures for transactions that qualify as a discontinued operation and requires disclosure of individually significant components that are disposed of or held for sale but do not qualify for discontinued operations reporting. This guidance is effective prospectively for all disposals or components initially classified as held for sale in periods beginning on or after December 15, 2014, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material effect on its consolidated financial statements.

In May 2014, the FASB issued 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. This guidance will be effective for the Company for its fiscal year 2017. The Company is currently evaluating the potential impact of this guidance.

In August 2014, the FASB issued ASU No. 2014-15, Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern. ASU No. 2014-15 requires management to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures in certain circumstances. This guidance will be effective for the Company for its fiscal year 2017, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material effect on its consolidated financial statements.

**Table of Contents****SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(UNAUDITED) continued****3. Fair Value Measurements**

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

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

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

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

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

The determination of fair values of certain tangible and intangible assets for purposes of the Company's goodwill impairment evaluation as described above was based upon a step zero assessment. Closed store reserves are recorded at net present value to approximate fair value which is classified as Level 3 in the hierarchy. The estimated fair value of the closed store reserve is calculated based on the present value of the remaining lease payments and other charges using a weighted average cost of capital, reduced by estimated sublease rentals. The weighted average cost of capital was estimated using information from comparable companies and management's judgment related to the risk associated with the operations of the stores.

Cash and cash equivalents, accounts receivable, prepaid expenses and other current assets, accounts payable, accrued salaries and benefits and other accrued liabilities approximate fair value because of the short maturity of those instruments. Based on open market transactions comparable to the Term Loan (as defined in Note 6, Long-Term Debt), the fair value of the long-term debt, including current maturities, approximates carrying value as of September 28, 2014 and December 29, 2013. The Company's estimates of the fair value of long-term debt (including current maturities) were classified as Level 2 in the fair value hierarchy.

**4. Accounts Receivable**

A summary of accounts receivable is as follows:

|                               | As Of                 |                      |
|-------------------------------|-----------------------|----------------------|
|                               | September 28,<br>2014 | December 29,<br>2013 |
| Vendor                        | \$ 8,731              | \$ 5,183             |
| Receivables from landlords    | 3,094                 | 1,034                |
| Medical insurance receivables | 37                    | 1,089                |
| Other                         | 2,215                 | 2,218                |
| <b>Total</b>                  | <b>\$ 14,077</b>      | <b>\$ 9,524</b>      |

Medical insurance receivables relate to amounts receivable from the Company's health insurance carrier for claims in excess of stop-loss limits.

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The Company had recorded allowances for certain vendor receivables of \$0.1 million and \$0.3 million at September 28, 2014 and December 29, 2013, respectively.

**Table of Contents****SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(UNAUDITED) continued****5. Accrued Salaries and Benefits**

A summary of accrued salaries and benefits is as follows:

|                 | September 28,<br>2014 | As Of<br>December 29,<br>2013 |
|-----------------|-----------------------|-------------------------------|
| Bonuses         | \$ 10,074             | \$ 8,393                      |
| Accrued payroll | 7,718                 | 6,904                         |
| Vacation        | 7,363                 | 6,634                         |
| Other           | 506                   | 356                           |
| <b>Total</b>    | <b>\$ 25,661</b>      | <b>\$ 22,287</b>              |

**6. Long-Term Debt**

A summary of long-term debt is as follows:

| Facility                                      | Maturity   | Interest Rate | September 28,<br>2014 | As Of<br>December 29,<br>2013 |
|-----------------------------------------------|------------|---------------|-----------------------|-------------------------------|
| <b>Senior Secured</b>                         |            |               |                       |                               |
| Term Loan, net of original issue discount     | April 2020 | Variable      | \$ 257,856            | \$ 311,240                    |
| \$60.0 million Revolving Credit Facility      | April 2018 | Variable      |                       |                               |
| <b>Total debt</b>                             |            |               | 257,856               | 311,240                       |
| Less current portion                          |            |               | (6,008)               | (5,822)                       |
| <b>Long-term debt, net of current portion</b> |            |               | <b>\$ 251,848</b>     | <b>\$ 305,418</b>             |

Current portion of long-term debt is presented net of issue discount of \$1.0 million and \$1.2 million as of September 28, 2014 and December 29, 2013, respectively. The non-current portion of long-term debt is presented net of issue discount of \$4.2 million and \$5.8 million as of September 28, 2014 and December 29, 2013, respectively.

**Senior Secured Credit Facilities***April 2013 Refinancing*

On April 23, 2013, the Company's subsidiary, Sprouts Farmers Markets Holdings, LLC ( "Intermediate Holdings" ), as borrower, refinanced (the "April 2013 Refinancing" ) its former revolving credit facility and former term loan, by entering into a new credit facility (the "Credit Facility" ). The Credit Facility provides for a \$700.0 million term loan (the "Term Loan" ) and a \$60.0 million senior secured revolving credit facility (the "Revolving Credit Facility" ).

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The terms of the Credit Facility allow the Company, subject to certain conditions, to increase the amount of the term loans and revolving commitments thereunder by an aggregate incremental amount of up to \$160.0 million, plus an additional amount, so long as after giving effect to such increase, (i) in the case of incremental loans that rank pari passu with the initial term loans, the net first lien leverage ratio does not exceed 4.00 to 1.00, and (ii) in the case of incremental loans that rank junior to the initial Term Loan, the total leverage ratio does not exceed 5.25 to 1.00.

### *Guarantees*

Obligations under the Credit Facility are guaranteed by the Company and all of its current and future wholly owned material domestic subsidiaries. Borrowings under the Credit Facility are secured by (i) a pledge by Sprouts of its equity interests in Intermediate Holdings and (ii) first-priority liens on substantially all assets of Intermediate Holdings and the subsidiary guarantors, in each case, subject to permitted liens and certain exceptions.

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**SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED) continued**

*Interest and Applicable Margin*

All amounts outstanding under the Credit Facility will bear interest, at the Company's option, at a rate per annum equal to LIBOR (with a 1.00% floor with respect to Eurodollar borrowings under the Term Loan), adjusted for statutory reserves, plus a margin equal to 3.00%, or an alternate base rate, plus a margin equal to 2.00%, as set forth in the Credit Facility. These interest margins were reduced to their current levels (from 3.50% and 2.50%, respectively) effective August 2, 2013, as a result of (i) the consummation of the Company's IPO, and (ii) the Company achieving a reduction in the net first lien leverage ratio to less than or equal to 2.75 to 1.00.

*Payments and Prepayments*

On August 14, 2014 the Company made a \$50.0 million voluntary principal payment on the Term Loan. Such payment resulted in a \$1.1 million loss on extinguishment of debt due to the write-off of deferred financing costs and original issue discount for the portion of the debt repaid. This loss on extinguishment of debt is reflected in the Company's statements of operations for the thirteen and thirty-nine weeks ended September 28, 2014.

The Term Loan will mature in April 2020 and will amortize at a rate per annum, in four equal quarterly installments, in an aggregate amount equal to 1.00% of the original principal balance, with the balance due on the maturity date.

Subject to exceptions set forth therein, the Credit Facility requires mandatory prepayments in amounts equal to (i) 50% (reduced to 25% if net first lien leverage is less than 3.00 to 1.00 but greater than 2.50 to 1.00 and 0% if net first lien leverage is less than 2.50 to 1.00) of excess cash flow (as defined in the Credit Facility) at the end of each fiscal year, (ii) 100% of the net cash proceeds from certain non-ordinary course asset sales by the Company or any subsidiary guarantor (subject to certain exceptions and reinvestment provisions) and (iii) 100% of the net cash proceeds from the issuance or incurrence of debt by the Company or any of its subsidiaries not permitted under the Credit Facility.

Voluntary prepayments of borrowings under the Credit Facility are permitted at any time, in agreed-upon minimum principal amounts. Prepayments will not be subject to premium or penalty (except LIBOR breakage costs, if applicable).

*Revolving Credit Facility*

The Credit Facility includes a \$60.0 million Revolving Credit Facility which matures in April 2018. The Revolving Credit Facility includes letter of credit and \$5.0 million swingline loan subfacilities. Letters of credit issued under the facility reduce the borrowing capacity on the total facility. There are no amounts outstanding on the Revolving Credit Facility at September 28, 2014. Letters of credit totaling \$7.4 million have been issued as of September 28, 2014 primarily to support the Company's insurance programs. Amounts available under the Revolving Credit Facility at September 28, 2014 totaled \$52.6 million.

Interest terms on the Revolving Credit Facility are the same as the Term Loan.

The Company capitalized debt issuance costs of \$1.1 million related to the Revolving Credit Facility, which are being amortized to interest expense over the term of the Revolving Credit Facility.

Under the terms of the Credit Facility, the Company is obligated to pay a commitment fee on the available unused amount of the Revolving Credit Facility commitments equal to 0.50% per annum.

*Covenants*

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

incur additional indebtedness;

grant additional liens;

enter into sale-leaseback transactions;

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make loans or investments;

merge, consolidate or enter into acquisitions;

pay dividends or distributions;

enter into transactions with affiliates;

enter into new lines of business;

modify the terms of subordinated debt or other material agreements; and

change its fiscal year

Each of these covenants is subject to customary or agreed-upon exceptions, baskets and thresholds.

In addition, if the Company has any amounts outstanding under the Revolving Credit Facility as of the last day of any fiscal quarter, the Revolving Credit Facility requires the borrower to maintain a ratio of Revolving Facility Credit exposure to consolidated trailing 12-month EBITDA (as defined in the Credit Facility) of no more than 0.75 to 1.00 as of the end of each such fiscal quarter.

The Company was in compliance with all applicable covenants under the Credit Facility as of September 28, 2014.

**7. Closed Store Reserves**

The following is a summary of closed store reserve activity during the thirty-nine weeks ended September 28, 2014 and fiscal year ended December 29, 2013:

|                   | <b>September 28,<br/>2014</b> | <b>December 29,<br/>2013</b> |
|-------------------|-------------------------------|------------------------------|
| Beginning balance | \$ 4,713                      | \$ 5,243                     |
| Additions         | 688                           | 363                          |
| Usage             | (1,407)                       | (1,728)                      |
| Adjustments       | (586)                         | 835                          |
| Ending balance    | \$ 3,408                      | \$ 4,713                     |

Additions made during 2014 relate to the closure and relocation of one store and to the closure and relocation of the Texas warehouse, and usage during 2014 relates to lease payments made during the period for closed stores. Adjustments made during 2014 include a \$0.4 million favorable

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reserve adjustment due to a sublease for the Sunflower administrative office and a \$1.2 million favorable reserve adjustment for one store due to settlement with the landlord recorded during the thirteen weeks ended September 28, 2014. Also during the thirteen weeks ended September 28, 2014, the Company determined that it should have been recording accretion expense for store closure reserves and liability for certain occupancy costs. The Company made a correcting entry of \$0.9 million to adjust the liability for closed stores to include such accretion and liability for certain occupancy costs for prior periods. The effect of this error on the Company's financial statements was not material to any period. Activity during 2013 includes charges related to the closure of a former Sunflower warehouse, lease payments made during the period for closed stores and adjustments to sublease estimates for stores and facilities already closed.

### **8. Income Taxes**

The Company's effective tax rate for the thirteen weeks ended September 28, 2014 and September 29, 2013 was 38.9% and 38.3%, respectively. The primary reasons for the increase in the effective tax rate were the result of a reduction in the net deferred tax asset because of a decrease in the statutory state income tax rate and a reduction in the deferred tax asset for income tax credits partially offset by provision to tax return adjustments for the 2013 income tax return. The impacts of the items noted above were recorded in the quarter.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED) continued**

The Company's effective tax rate for the thirty-nine weeks ended September 28, 2014 and September 29, 2013 was 38.9% and 39.3%, respectively. The decrease in the effective tax rate was the result of an increase in the enhanced charitable food contribution.

In September 2013, the Internal Revenue Service issued final regulations related to tangible property, which govern when a taxpayer must capitalize or deduct expenses for acquiring, maintaining, repairing and replacing tangible property. The regulations are effective for tax years beginning January 1, 2014, however early adoption is permitted. The Company has analyzed the impacts of the tangible property regulations, and has determined it is in compliance with the regulations. The adoption of the regulations has not had a material effect on the Company's consolidated financial statements.

Excess tax benefits associated with stock option exercises are credited to stockholders' equity. The Company uses the tax law ordering approach of intraperiod allocation to allocate the benefit of windfall tax benefits based on provisions in the tax law that identify the sequence in which those amounts are utilized for tax purposes. The income tax benefits resulting from stock awards that were credited to stockholders' equity were \$35.0 million for the thirty-nine weeks ended September 28, 2014, which included \$1.5 million of income tax benefits related to stock award activity in 2013. The income tax benefits resulting from antidilution payments that were credited to stockholders' equity were \$4.4 million for the thirty-nine weeks ended September 29, 2013. The excess tax benefits are not credited to stockholders' equity until the deduction reduces income taxes payable.

**9. Related-Party Transactions**

Two stockholders, including a member of the Company's board of directors, are investors in a company that is a supplier of coffee to the Company. During the thirteen weeks ended September 28, 2014 and September 29, 2013, purchases from this company were \$2.0 million and \$1.7 million, respectively. During the thirty-nine weeks ended September 28, 2014 and September 29, 2013, purchases from this company were \$5.8 million and \$5.6 million, respectively. At both September 28, 2014 and September 29, 2013, the Company had recorded accounts payable due to this vendor of \$0.6 million.

The Company was party to a services agreement (the "Services Agreement") with an outsourced service provider who is a stockholder of the Company, to perform certain of the Company's bookkeeping services including general ledger maintenance, accounts payable processing and cash management. The Services Agreement provides for successive one-year terms unless either party provides six months' termination notice. During the thirteen weeks ended September 28, 2014 and September 29, 2013, fees and other expenses paid to the service provider under the terms of the Services Agreement were \$0.1 million and \$0.6 million, respectively. During the thirty-nine weeks ended September 28, 2014 and September 29, 2013, fees and other expenses paid to the service provider under the terms of the Services Agreement were \$1.0 million and \$1.8 million, respectively. The Services Agreement expired in accordance with its terms on September 1, 2014.

**10. Commitments and Contingencies**

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

**11. Stockholders' Equity**

***Secondary Offerings***

On April 2, 2014, certain of the Company's stockholders completed a secondary public offering of 17,250,000 shares of common stock, which included 1.6 million options exercised and sold by certain of the Company's option holders (the "April Secondary Offering"). On August 18, 2014, certain of the Company's stockholders completed a secondary public offering of 17,158,191 shares of common stock,



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which included 0.7 million options exercised and sold by certain of the Company's option holders (the August Secondary Offering). See Note 13, Equity-Based Compensation for more details on the option exercises in the April Secondary Offering and the August Secondary Offering. The Company did not sell any shares in either the April Secondary Offering or the August Secondary Offering.

***Initial Public Offering***

On August 6, 2013, the Company completed its IPO of 21,275,000 shares of common stock at a price of \$18.00 per share. The Company sold 20,477,215 shares of common stock, and certain stockholders sold the remaining 797,785 shares. The Company received gross proceeds from the IPO of approximately \$368.6 million, or \$344.1 million after deducting underwriting discounts and offering expenses of \$24.5 million. The Company did not receive any proceeds from the sale of shares by the selling stockholders. On August 6, 2013, the Company used \$340.0 million of the net proceeds from its IPO to make a partial repayment of the Term Loan.

***Distribution to Stockholders***

On April 24, 2013, the Company paid a total distribution of \$282.0 million to stockholders. Additionally, pursuant to the anti-dilution provisions of the 2011 Option Plan (as defined in Note 13 Equity-Based Compensation below), the Company paid \$13.9 million to certain vested option holders and reduced the exercise price of unvested and certain vested options.

The payment was made first from retained earnings to date as of the payment date, and payment in excess of retained earnings was made from additional paid-in capital.

**12. Net Income Per Share**

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

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

|                                     | <b>Thirteen Weeks Ended</b>   |                               | <b>Thirty-Nine Weeks Ended</b> |                               |
|-------------------------------------|-------------------------------|-------------------------------|--------------------------------|-------------------------------|
|                                     | <b>September 28,<br/>2014</b> | <b>September 29,<br/>2013</b> | <b>September 28,<br/>2014</b>  | <b>September 29,<br/>2013</b> |
| Basic net income per share:         |                               |                               |                                |                               |
| Net income                          | \$ 26,065                     | \$ 11,461                     | \$ 89,949                      | \$ 42,046                     |
| Weighted average shares outstanding | 150,241                       | 139,687                       | 149,227                        | 130,538                       |
| Basic net income per share          | \$ 0.17                       | \$ 0.08                       | \$ 0.60                        | \$ 0.32                       |
| Diluted net income per share:       |                               |                               |                                |                               |
| Net income                          | \$ 26,065                     | \$ 11,461                     | \$ 89,949                      | \$ 42,046                     |
| Weighted average shares outstanding | 150,241                       | 139,687                       | 149,227                        | 130,538                       |

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Dilutive effect of equity-based awards:

|                                                |       |       |       |       |
|------------------------------------------------|-------|-------|-------|-------|
| Assumed exercise of options to purchase shares | 4,065 | 5,023 | 4,652 | 3,991 |
|------------------------------------------------|-------|-------|-------|-------|

Weighted average shares and equivalent shares outstanding

|         |         |         |         |
|---------|---------|---------|---------|
| 154,306 | 144,710 | 153,879 | 134,529 |
|---------|---------|---------|---------|

|                              |         |         |         |         |
|------------------------------|---------|---------|---------|---------|
| Diluted net income per share | \$ 0.17 | \$ 0.08 | \$ 0.58 | \$ 0.31 |
|------------------------------|---------|---------|---------|---------|

For the thirteen weeks ended September 28, 2014 the computation of diluted net income per share does not include 1.0 million options as those options would have been antidilutive or were unvested performance-based options. For the thirteen weeks ended September 29, 2013, the computation of diluted net income per share does not include 2.6 million options, as those options would have been antidilutive or were unvested performance-based options.

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**SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(UNAUDITED) continued**

For the thirty-nine weeks ended September 28, 2014 the computation of diluted net income per share does not include 1.0 million options as those options would have been antidilutive or were unvested performance-based options. For the thirty-nine weeks ended September 29, 2013, the computation of diluted net income per share does not include 4.5 million options, as those options would have been antidilutive or were unvested performance-based options.

**13. Equity-Based Compensation**

***2013 Incentive Plan***

The Company's board of directors adopted, and its equity holders approved, the Sprouts Farmers Market, Inc. 2013 Incentive Plan (the "2013 Incentive Plan"). The 2013 Incentive Plan became effective July 31, 2013 in connection with the Company's IPO and replaced the Sprouts Farmers Markets, LLC Option Plan (the "2011 Option Plan") (except with respect to outstanding options to acquire shares under the 2011 Option Plan). The 2013 Incentive Plan and 2011 Option Plan are collectively referred to as the "Option Plans". The 2013 Incentive Plan serves as the umbrella plan for the Company's stock-based and cash-based incentive compensation programs for its directors, officers and other team members.

Under the 2013 Incentive Plan, effective July 31, 2013 upon the pricing of the Company's IPO, the Company granted officers and team members options to purchase 396,000 shares of common stock at an exercise price of \$18.00 per share, with grant date fair values of \$4.65 to \$5.92. The Company also granted to independent directors options to purchase 11,112 shares of common stock at an exercise price of \$18.00 per share, with grant date fair values of \$4.65.

On March 4, 2014, under the 2013 Incentive Plan, the Company granted to certain officers and team members time-based options to purchase an aggregate of 320,041 shares of common stock at an exercise price of \$39.01 per share, with a grant date fair value of \$10.66 per share. The Company also granted an aggregate of 108,980 RSUs with a grant date fair value of \$39.01.

On May 19, 2014, under the 2013 Incentive Plan, the Company granted to a team member and to independent members of the Company's board of directors time-based options to purchase an aggregate of 37,047 shares of common stock at an exercise price of \$28.50 per share, with a grant date fair value of \$8.07. The Company also granted to this team member 2,174 RSUs with a grant date fair value of \$28.50 per share.

The aggregate number of shares of common stock that may be issued to team members and directors under the 2013 Incentive Plan may not exceed 10,089,072. Shares subject to awards granted under the 2013 Incentive Plan which are subsequently forfeited, expire unexercised or are otherwise not issued will not be treated as having been issued for purposes of the share limitation.

***2011 Option Plan***

In May 2011, the Company adopted the 2011 Option Plan to provide team members or directors of the Company with options to acquire shares of the Company. The Company had authorized 12,100,000 shares for issuance under the 2011 Option Plan. Options may no longer be issued under the 2011 Option Plan.

During the thirty-nine weeks ended September 29, 2013, the Company awarded 209,000 options to employees under the 2011 Option Plan at exercise prices of \$9.15 and grant date fair values of \$2.33 to \$3.10.

**Table of Contents****SPROUTS FARMERS MARKET, INC. AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(UNAUDITED) continued*****Options***

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

Time-based options generally vest ratably over a period of 12 quarters (three years) and performance-based options vest over a period of three years based on financial performance targets set for each year.

***RSUs***

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

***Equity-based Compensation Expense***

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

|                                                       | <b>Thirteen Weeks Ended</b>   |                               | <b>Thirty-Nine Weeks Ended</b> |                               |
|-------------------------------------------------------|-------------------------------|-------------------------------|--------------------------------|-------------------------------|
|                                                       | <b>September 28,<br/>2014</b> | <b>September 29,<br/>2013</b> | <b>September 28,<br/>2014</b>  | <b>September 29,<br/>2013</b> |
| Cost of sales, buying and occupancy                   | \$ 152                        | \$ 164                        | \$ 546                         | \$ 481                        |
| Direct store expenses                                 | 215                           | 22                            | 580                            | 81                            |
| Selling, general and administrative expenses          | 832                           | 1,433                         | 3,068                          | 3,723                         |
| Equity-based compensation expense before income taxes | 1,199                         | 1,619                         | 4,194                          | 4,285                         |
| Income tax benefit                                    | (480)                         | (620)                         | (1,678)                        | (1,684)                       |
| Net equity-based compensation expense                 | \$ 719                        | \$ 999                        | \$ 2,516                       | \$ 2,601                      |

Net equity-based compensation expense for the thirty-nine weeks ended September 29, 2013 included additional expense of \$0.5 million related to anti-dilution provision payments made to certain option holders. See Note 11, *Stockholders' Equity* for more information. As of September 28, 2014 and December 29, 2013, there were approximately 8.1 million and 10.9 million options outstanding and 1.5 million and 2.7 million unvested options outstanding, respectively.

As of September 28, 2014 and December 29, 2013, there were approximately 0.1 million and no unvested RSUs outstanding, respectively.

As of September 28, 2014, total unrecognized compensation expense related to outstanding options was \$4.4 million which, if the service and performance conditions are fully met, is expected to be recognized over the next 1.1 years on a weighted-average basis.

As of September 28, 2014, total unrecognized compensation expense related to outstanding RSUs was \$3.2 million which, if the service conditions are fully met, is expected to be recognized over the next 2.0 years on a weighted-average basis.

During the thirty-nine weeks ended September 28, 2014, the Company received \$7.6 million in cash proceeds from the exercise of options, including a total of 2.3 million options exercised by current or former team members who sold the underlying shares in the April Secondary

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Offering and in the August Secondary Offering.

During the thirty-nine weeks ended September 29, 2013, the Company received \$0.1 million in cash proceeds from the exercise of options.

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### **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*You should read the following discussion of our financial condition and results of operations in conjunction with the consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K filed February 27, 2014 with the Securities and Exchange Commission. All dollar amounts included below are in thousands, unless otherwise noted.*

#### **Business Overview**

Sprouts Farmers Market, Inc. operates as a healthy grocery store that offers fresh, natural and organic food that includes fresh produce, bulk foods, vitamins and supplements, grocery, meat and seafood, bakery, dairy, frozen foods, body care and natural household items catering to consumers' growing interest in eating and living healthier. Since our founding in 2002, we have grown rapidly, significantly increasing our sales, store count and profitability. With 191 stores in ten states as of September 28, 2014, we are one of the largest specialty retailers of natural and organic food in the United States.

The cornerstones of our business are fresh, natural and organic products at compelling prices (which we refer to as "Healthy Living for Less"), an attractive and differentiated shopping experience, and knowledgeable team members who we believe provide best-in-class customer service and product education.

**Healthy Living For Less.** The foundation of our value proposition is fresh, high-quality produce which we offer at prices we believe are significantly below those of conventional food retailers and even further below high-end natural and organic food retailers. We believe that by combining our scale in and self-distribution of produce, we ensure that our produce meets our high quality standards and can be delivered to customers at market leading prices. In addition, our scale, operating structure and deep industry relationships position us to consistently deliver

"Healthy Living for Less." Based on our experience, we believe we attract a broad customer base, including conventional supermarket customers, and appeal to a much wider demographic than other specialty retailers of natural and organic food. Trial visits to our stores allow us to engage with customers while showcasing our complete grocery offering and differentiated retail format. We believe that over time, our compelling prices and product offering convert many trial customers into loyal lifestyle customers who shop Sprouts with greater frequency and across an increasing number of departments.

**Attractive, Differentiated Shopping Experience.** In a convenient, small-box format (average store size of 27,500 sq. ft.), our stores have a farmers market feel, with easy-to-shop floor plans, a bright open-air atmosphere and low profile displays allowing customers to view the entire store upon entry. We design our stores to create a comfortable and engaging shopping experience supported by our well-trained and knowledgeable team members. We strive to be our customers' everyday market. We dedicate significant floor space in the center of our stores to our produce and bulk food departments which we merchandise in bountifully stacked crates and rows of self-service bins creating a farmers market environment. Produce and bulk foods at the center of the store are surrounded by a complete grocery offering, including vitamins and supplements, grocery, meat and seafood, bakery, dairy, frozen foods, beer and wine, body care and natural household items. Consistent with our natural and organic offering, we choose not to carry most of the traditional, national branded consumer packaged goods generally found at conventional grocery retailers (e.g., Doritos, Tide and Lucky Charms). Instead, we offer high-quality alternatives that emphasize our focus on fresh, natural and organic products at great values.

**Customer Service & Education.** We are dedicated to our mission of "Healthy Living for Less," and we attract team members who share our passion for educating and serving our customers with the goal of making healthy eating easier and more accessible. Our passionate and well-trained team

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members engage customers throughout the entire store and provide them with product and nutritional education. As a result, we believe our customers increasingly understand that they can purchase a wide selection of high-quality, healthy, and great tasting food for themselves and their families at attractive prices by shopping at Sprouts. Over time, we believe our customers become passionate about both Sprouts and eating healthy, and we experience growing sales as they shop Sprouts for a greater percentage of their grocery needs.

### **Outlook**

We are pursuing a number of strategies designed to continue our growth, including expansion of our store base, driving comparable store sales growth, enhancing our operating margins and growing the Sprouts brand. We intend to continue expanding our store base by pursuing new store openings in our existing markets, expanding into adjacent markets and penetrating new markets. We opened 24 stores and relocated one store during 2014. Although we plan to expand our store base primarily through new store openings, we may grow through strategic acquisitions if we identify suitable targets and are able to negotiate acceptable terms and conditions for acquisition. We intend to achieve 14% annual new store growth for at least the next five years.

We also believe we can continue to improve our comparable store sales growth by enhancing our core value proposition and distinctive customer-oriented shopping experience, as well as through expanding and refining our fresh, natural and organic product offerings, our targeted and personalized marketing efforts and our in-store education. We believe our operating margins will continue to benefit from scale efficiencies, continued cost discipline and enhancements to our merchandise offerings. We are committed to growing the Sprouts brand by supporting our stores, product offerings and corporate partnerships, including the expansion of innovative marketing and promotional strategies through print, digital and social media platforms, all of which promote our mission of Healthy Living for Less.

### **Our History**

In 2002, we opened the first Sprouts Farmers Market store in Chandler, Arizona. In 2010, we had 54 stores and reached over \$620 million in net sales and approximately 3,700 team members. In April 2011, we partnered with investment funds affiliated with, and co-investment vehicles managed by, Apollo Management VI, L.P., and added 43 stores by merging with Henry's Holdings, LLC (referred to as Henry's) and its Sun Harvest-brand stores. Our merger with Henry's and new store openings brought us to 103 total stores located in Arizona, California, Colorado and Texas as of the end of 2011. In May 2012, we added another 37 stores through our acquisition of Sunflower Farmers Markets, Inc. (referred to as Sunflower) and extended our footprint into New Mexico, Nevada, Oklahoma and Utah. On August 1, 2013, our common stock began trading on the NASDAQ Global Select Market and on August 6, 2013, we closed our initial public offering (referred to as our IPO). Since the IPO, we have continued to expand, adding 28 stores through the date of this filing and extending to Kansas and Georgia.

### **Components of Operating Results**

We report our results of operations on a 52- or 53-week fiscal year ending on the Sunday closest to December 31, with each fiscal quarter generally divided into three periods consisting of two four-week periods and one five-week period. The third quarters of fiscal 2014 and 2013 were thirteen-week periods ended September 28, 2014 and September 29, 2013, respectively.

#### ***Net Sales***

We recognize sales revenue at the point of sale, with discounts provided to customers reflected as a reduction in sales revenue. Proceeds from sales of gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer. We do not include sales taxes in net sales.

We monitor our comparable store sales growth to evaluate and identify trends in our sales performance. Our practice is to include sales from a store in comparable store sales beginning on the first

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

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

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

consumer preferences and buying trends;

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

the number of customer transactions and average ticket;

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

opening new stores in the vicinity of our existing stores;

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

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

### ***Cost of sales, buying and occupancy and gross profit***

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

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

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

### ***Direct store expenses***

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

generally decline as a percentage of sales.

***Selling, general and administrative expenses***

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

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

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### ***Store pre-opening costs***

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

### ***Store closure and exit costs***

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

### ***Provision for income taxes***

Prior to our IPO, we were structured as a limited liability company, but we elected to be taxed as a corporation for income tax purposes. We are subject to federal income tax as well as state income tax in various jurisdictions of the United States in which we conduct business. Income taxes are accounted for under the asset and liability method.

On July 29, 2013, Sprouts Farmers Markets, LLC, a Delaware limited liability company, converted into Sprouts Farmers Market, Inc., a Delaware corporation, as described under Factors Affecting Comparability of Results of Operations Corporate Conversion. The corporate conversion has not had a material impact on our results of operations, financial position or cash flows since we were treated as a corporation for income tax purposes prior to the conversion.

In September 2013, the Internal Revenue Service issued final regulations related to tangible property, which govern when a taxpayer must capitalize or deduct expenses for acquiring, maintaining, repairing and replacing tangible property. The regulations are effective for tax years beginning January 1, 2014; however, early adoption is permitted. We have analyzed the impacts of the tangible property regulations, and have determined we are in compliance with the regulations. The adoption of the regulations did not have a material effect on our consolidated financial statements.

## **Factors Affecting Comparability of Results of Operations**

### ***April 2013 Refinancing***

In April 2013, we completed a transaction (referred to as the April 2013 Refinancing) in which we refinanced our debt by entering into a new credit facility (referred to as the Credit Facility) and made a distribution to our equity and option holders, as further discussed in Note 6

Long-Term Debt and Note 11 Stockholders Equity to our consolidated financial statements included in this Quarterly Report on Form 10-Q. The Credit Facility provides for a \$700.0 million term loan (referred to as the Term Loan) and a \$60.0 million senior secured revolving credit facility (referred to as the Revolving Credit Facility). The April 2013 Refinancing resulted in an increase in borrowings and reduction in interest rate commencing in April 2013.

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### ***Corporate Conversion***

On July 29, 2013, Sprouts Farmers Markets, LLC, a Delaware limited liability company, converted into Sprouts Farmers Market, Inc., a Delaware corporation. As part of the corporate conversion, holders of Class A and Class B units of Sprouts Farmers Markets, LLC received 11 shares of our common stock for each unit held immediately prior to the corporate conversion, and options to purchase units became options to purchase 11 shares of our common stock for each unit underlying options outstanding immediately prior to the corporate conversion, at the same aggregate exercise price in effect prior to the corporate conversion. For the convenience of the reader and in accordance with GAAP in the case of the consolidated financial statements, except where the context otherwise requires, information in this Quarterly Report on Form 10-Q has been presented giving effect to the corporate conversion. The corporate conversion has not had a material impact on the comparability of our results of operation as a result of the corporate conversion, since we have been treated as a corporation for income tax purposes.

### ***IPO***

On August 6, 2013, we completed our initial public offering of 21,275,000 shares of common stock of Sprouts Farmers Market, Inc., at a price of \$18.00 per share. We sold 20,477,215 shares of common stock, and certain stockholders sold the remaining 797,785 shares.

We received net proceeds from our IPO of \$344.1 million, after deducting underwriting discounts and offering expenses. We used the net proceeds to repay \$340.0 million of outstanding indebtedness under the Term Loan and the remainder for general corporate purposes.

### ***Secondary Offerings***

On December 2, 2013, certain of our stockholders completed a secondary public offering of 19,550,000 shares of common stock, including 2,550,000 shares of common stock sold as a result of the exercise in full of the underwriters' option to purchase additional shares, at a price of \$37.00 per share (referred to as the December Secondary Offering).

On April 2, 2014, certain of our stockholders completed a secondary public offering of 17,250,000 shares of common stock, including 2,250,000 shares of common stock sold as a result of the exercise in full of the underwriters' option to purchase additional shares, at a price of \$33.75 per share (referred to as the April Secondary Offering).

On August 18, 2014, certain of our stockholders completed a secondary public offering of 17,158,191 shares of common stock, including 2,158,191 shares of common stock sold as a result of the partial exercise of the underwriters' option to purchase additional shares, at a price of \$30.00 per share (referred to as the August Secondary Offering).

We did not sell any shares in the December, April or the August Secondary Offerings.

**Table of Contents****Results of Operations for Thirteen Weeks Ended September 28, 2014 and September 29, 2013**

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

|                                                                       | Thirteen weeks ended |                    |
|-----------------------------------------------------------------------|----------------------|--------------------|
|                                                                       | September 28, 2014   | September 29, 2013 |
| <b>Unaudited Quarterly Consolidated Statement of Operations Data:</b> |                      |                    |
| Net sales                                                             | \$ 766,415           | \$ 633,614         |
| Cost of sales, buying and occupancy                                   | 540,367              | 443,509            |
| Gross profit                                                          | 226,048              | 190,105            |
| Direct store expenses                                                 | 148,633              | 129,418            |
| Selling, general and administrative expenses                          | 24,015               | 22,807             |
| Store pre-opening costs                                               | 3,684                | 1,237              |
| Store closure and exit costs                                          | 60                   | (38)               |
| Income from operations                                                | 49,656               | 36,681             |
| Interest expense                                                      | (6,157)              | (8,790)            |
| Other income                                                          | 281                  | 203                |
| Loss on extinguishment of debt                                        | (1,138)              | (9,507)            |
| Income before income taxes                                            | 42,642               | 18,587             |
| Income tax provision                                                  | (16,577)             | (7,126)            |
| Net income                                                            | \$ 26,065            | \$ 11,461          |

|                                         | Thirteen weeks ended |                    |
|-----------------------------------------|----------------------|--------------------|
|                                         | September 28, 2014   | September 29, 2013 |
| <b>Comparable store sales growth(1)</b> | 9.0%                 | 10.2%              |
| <b>Other Operating Data:</b>            |                      |                    |
| Stores at beginning of period           | 177                  | 160                |
| Opened                                  | 14                   | 7                  |
| Stores at end of period                 | 191                  | 167                |

(1) See the explanation of Comparable store sales growth above under Components of Operating Results Net Sales.

**Comparison of Thirteen Weeks Ended September 28, 2014 to Thirteen Weeks Ended**

**September 29, 2013**

*Net sales*

**Thirteen weeks ended**

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|                               | September 28, 2014 | September 29, 2013 | Change     | % Change |
|-------------------------------|--------------------|--------------------|------------|----------|
| Net sales                     | \$ 766,415         | \$ 633,614         | \$ 132,801 | 21%      |
| Comparable store sales growth | 9.0%               | 10.2%              |            |          |

Net sales increased during the thirteen weeks ended September 28, 2014 as compared to the thirteen weeks ended September 29, 2013, primarily as a result of (i) new store openings after September 29, 2013 and (ii) sales growth at stores operated prior to September 29, 2013. New store openings after

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September 29, 2013 contributed \$68.1 million, or 51%, of the increase in net sales during the thirteen weeks ended September 28, 2014. Additionally, \$64.7 million, or 49%, of the increase came from comparable store sales growth and new store openings during fiscal 2013 not yet reflected in comparable store sales.

***Cost of sales, buying and occupancy and gross profit***

|                                     | Thirteen weeks ended |                    | Change     | % Change |
|-------------------------------------|----------------------|--------------------|------------|----------|
|                                     | September 28, 2014   | September 29, 2013 |            |          |
| Net sales                           | \$ 766,415           | \$ 633,614         | \$ 132,801 | 21%      |
| Cost of sales, buying and occupancy | 540,367              | 443,509            | 96,858     | 22%      |
| Gross profit                        | 226,048              | 190,105            | 35,943     | 19%      |
| Gross margin                        | 29.5%                | 30.0%              | (0.5)%     |          |

Cost of sales, buying and occupancy increased during the thirteen weeks ended September 28, 2014 compared to the thirteen weeks ended September 29, 2013, primarily due to the increase in sales from new store openings and comparable store sales growth, as discussed above. Gross profit increased \$39.8 million as a result of increased sales volume. Gross margins were lower due to lower merchandise margins from price investments in certain categories and inflation in certain categories. Those decreases were partially offset by leverage in occupancy, utilities and buying costs.

***Direct store expenses***

|                         | Thirteen weeks ended |                    | Change    | % Change |
|-------------------------|----------------------|--------------------|-----------|----------|
|                         | September 28, 2014   | September 29, 2013 |           |          |
| Direct store expenses   | \$ 148,633           | \$ 129,418         | \$ 19,215 | 15%      |
| Percentage of net sales | 19.4%                | 20.4%              | (1.0)%    |          |

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Direct store expenses increased \$19.2 million, primarily due to \$15.3 million of direct store expenses related to stores opened since September 29, 2013 and a \$3.9 million increase in direct store expenses associated with stores operated prior to the thirteen weeks ended September 29, 2013. Direct store expenses, as a percentage of net sales, decreased 100 basis points primarily due to leverage in payroll and benefits, including lower utilization of medical benefits, leverage in depreciation and store level expenses and a benefit from capitalizing a higher amount for store development costs due to the greater number of stores opened during the thirteen weeks ended September 28, 2014 over the prior year.

***Selling, general and administrative expenses***

|                                              | Thirteen weeks ended |                    | Change   | % Change |
|----------------------------------------------|----------------------|--------------------|----------|----------|
|                                              | September 28, 2014   | September 29, 2013 |          |          |
| Selling, general and administrative expenses | \$ 24,015            | \$ 22,807          | \$ 1,208 | 5%       |
| Percentage of net sales                      | 3.1%                 | 3.6%               | (0.5)%   |          |

The increase in selling, general and administrative expenses included \$1.9 million for advertising expense, \$0.9 million for expenses related to the August Secondary Offering, \$0.8 million for corporate payroll to support growth and \$0.7 million for regional administration expense due to additional store count and growth into new regions; these increases were partially offset by \$3.2 million for IPO bonus in the prior year. Selling, general and administrative expenses decreased as a percent of net sales due to leveraging of corporate expenses and partially offset by higher advertising expense due to expansion into new markets.

***Store pre-opening costs***

Store pre-opening costs were \$3.7 million for the thirteen weeks ended September 28, 2014 and \$1.2 million for the thirteen weeks ended September 29, 2013. Store pre-opening costs in the thirteen weeks ended September 28, 2014 included \$3.6 million related to opening 14 stores during that period and \$0.1 million associated with stores opening during the next year. Store pre-opening costs in the thirteen weeks ended September 29, 2013 included \$1.1 million related to opening seven stores during that period and \$0.1 million for stores opened in the next year.

***Store closure and exit costs***

Store closure and exit costs for the thirteen weeks ended September 28, 2014 included a \$1.2 million favorable adjustment to reserve for settlement with a landlord, offset by changes in reserves for stores and facilities already closed and ongoing expenses related to those facilities. Additionally, we determined that we should have been recording accretion expense for store closure reserves and liability for certain occupancy costs. We made a correcting entry of \$0.9 million to adjust the liability for closed stores to include such accretion and liability for certain occupancy costs for prior periods. The effect of this entry was not material to any period. Store closure and exit costs for the thirteen weeks ended September 29, 2013 consisted of changes in reserves for stores and facilities already closed.

**Table of Contents*****Interest expense***

Interest expense decreased to \$6.2 million for the thirteen weeks ended September 28, 2014 from \$8.8 million for the thirteen weeks ended September 29, 2013. The decrease in interest expense is due to the lower principal balance of our Term Loan and the interest rate reduction under our Credit Facility in conjunction with our IPO.

***Loss on extinguishment of debt***

In the thirteen weeks ended September 28, 2014, we made a voluntary principal payment of \$50.0 million and wrote-off \$1.1 million of deferred financing costs and original issue discount related to that portion of the Term Loan.

In the thirteen weeks ended September 29, 2013, in connection with the August 2013 pay down of debt using proceeds from our IPO, we recorded a loss on extinguishment of debt totaling \$9.0 million primarily related to the write-off of deferred financing costs and original issue discount. Additionally, the loss on extinguishment of debt includes \$0.5 million related to the renewal of a financing lease.

***Income tax provision***

Income tax provision increased to \$16.6 million for the thirteen weeks ended September 28, 2014 from \$7.1 million for the thirteen weeks ended September 29, 2013, primarily related to an increase in income before income taxes. Our effective income tax rate increased to 38.9% in the thirteen weeks ended September 28, 2014 from 38.3% in the thirteen weeks ended September 29, 2013. The primary reasons for the increase in the effective tax rate were the result of a reduction in the net deferred tax asset because of a decrease in the statutory state income tax rate and a reduction in the deferred tax asset for income tax credits partially offset by provision to tax return adjustments for the 2013 income tax return. The impacts of the items noted above were recorded in the quarter.

***Net income***

|                         | Thirteen weeks ended |                    | Change    | % Change |
|-------------------------|----------------------|--------------------|-----------|----------|
|                         | September 28, 2014   | September 29, 2013 |           |          |
| Net income              | \$ 26,065            | \$ 11,461          | \$ 14,604 | 127%     |
| Percentage of net sales | 3.4%                 | 1.8%               | 1.6%      |          |

Net income growth was attributable to strong business performance driven by comparable store sales growth and resulting operating leverage, strong performance of new stores opened, lower loss on extinguishment of debt and reduced interest expense slightly offset by increase in advertising expense to support our growth into new markets.

**Table of Contents****Results of Operations for Thirty-Nine Weeks Ended September 28, 2014 and September 29, 2013**

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

|                                                                       | Thirty-Nine weeks ended |                    |
|-----------------------------------------------------------------------|-------------------------|--------------------|
|                                                                       | September 28, 2014      | September 29, 2013 |
| <b>Unaudited Quarterly Consolidated Statement of Operations Data:</b> |                         |                    |
| Net sales                                                             | \$ 2,232,831            | \$ 1,829,675       |
| Cost of sales, buying and occupancy                                   | 1,558,876               | 1,278,623          |
| Gross profit                                                          | 673,955                 | 551,052            |
| Direct store expenses                                                 | 430,019                 | 367,064            |
| Selling, general and administrative expenses                          | 69,594                  | 60,259             |
| Store pre-opening costs                                               | 7,051                   | 5,254              |
| Store closure and exit costs                                          | 393                     | 1,670              |
| Income from operations                                                | 166,898                 | 116,805            |
| Interest expense                                                      | (19,144)                | (30,346)           |
| Other income                                                          | 477                     | 447                |
| Loss on extinguishment of debt                                        | (1,138)                 | (17,682)           |
| Income before income taxes                                            | 147,093                 | 69,224             |
| Income tax provision                                                  | (57,144)                | (27,178)           |
| Net income                                                            | \$ 89,949               | \$ 42,046          |

|                                         | Thirty-Nine weeks ended |                    |
|-----------------------------------------|-------------------------|--------------------|
|                                         | September 28, 2014      | September 29, 2013 |
| <b>Comparable store sales growth(1)</b> | 10.4%                   | 9.7%               |
| <b>Other Operating Data:</b>            |                         |                    |
| Stores at beginning of period           | 167                     | 148                |
| Opened                                  | 24                      | 19                 |
| Stores at end of period(2)              | 191                     | 167                |

(1) See the explanation of Comparable store sales growth above under Components of Operating Results Net Sales.

(2) During the thirty-nine weeks ended September 28, 2014, we also relocated one store.

**Comparison of Thirty-Nine Weeks Ended September 28, 2014 to Thirty-Nine Weeks Ended****September 29, 2013*****Net sales***

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|                               | Thirty-Nine weeks ended |                    |            |          |
|-------------------------------|-------------------------|--------------------|------------|----------|
|                               | September 28, 2014      | September 29, 2013 | Change     | % Change |
| Net sales                     | \$ 2,232,831            | \$ 1,829,675       | \$ 403,156 | 22%      |
| Comparable store sales growth | 10.4%                   | 9.7%               |            |          |

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Net sales increased during the thirty-nine weeks ended September 28, 2014 as compared to the thirty-nine weeks ended September 29, 2013, primarily as a result of (i) sales growth at stores operated prior to September 29, 2013 and (ii) new store openings after September 29, 2013. Comparable store sales growth and new store openings during fiscal 2013 not yet reflected in comparable store sales growth contributed \$292.3 million, or 72%, of the increase in net sales during the thirty-nine weeks ended September 28, 2014. Additionally, \$110.8 million, or 28%, of the increase in net sales resulted from new store openings after September 29, 2013.

### Cost of sales, buying and occupancy and gross profit

|                                     | Thirty-nine weeks ended |                    |            |          |
|-------------------------------------|-------------------------|--------------------|------------|----------|
|                                     | September 28, 2014      | September 29, 2013 | Change     | % Change |
| Net sales                           | \$ 2,232,831            | \$ 1,829,675       | \$ 403,156 | 22%      |
| Cost of sales, buying and occupancy | 1,558,876               | 1,278,623          | 280,253    | 22%      |
| Gross profit                        | 673,955                 | 551,052            | 122,903    | 22%      |
| Gross margin                        | 30.2%                   | 30.1%              | 0.1%       |          |

Cost of sales, buying and occupancy increased during the thirty-nine weeks ended September 28, 2014 compared to the thirty-nine weeks ended September 29, 2013, primarily due to the increase in sales from new store openings and comparable store sales growth, as discussed above. Gross profit increased \$121.3 million as a result of increased sales volume and \$1.6 million as a result of increased margin. The 10 basis point increase in gross margin during the thirty-nine weeks ended September 28, 2014 was primarily driven by leverage in occupancy, utilities and buying costs partially offset by lower merchandise margins from price investments in certain categories and higher inflation in certain categories.

### Direct store expenses

|                         | Thirty-Nine weeks ended |                    |           |          |
|-------------------------|-------------------------|--------------------|-----------|----------|
|                         | September 28, 2014      | September 29, 2013 | Change    | % Change |
| Direct store expenses   | \$ 430,019              | \$ 367,064         | \$ 62,955 | 17%      |
| Percentage of net sales | 19.3%                   | 20.1%              | (0.8)%    |          |

Direct store expenses increased \$63.0 million, primarily due to a \$38.9 million increase for stores operated prior to the thirty-nine weeks ended September 29, 2013. The remaining \$24.1 million increase in direct store expenses is associated with stores opened since September 29, 2013. Direct store expenses, as a percentage of net sales, decreased 80 basis points, primarily due to leverage in payroll and benefits, including lower utilization of medical benefits, leverage in depreciation and store level expenses and a benefit from capitalizing a higher amount for store development costs due to the greater number of stores opened during the thirty-nine weeks ended September 28, 2014 over last year.

### Selling, general and administrative expenses

|                                              | Thirty-Nine weeks ended |                    |          |          |
|----------------------------------------------|-------------------------|--------------------|----------|----------|
|                                              | September 28, 2014      | September 29, 2013 | Change   | % Change |
| Selling, general and administrative expenses | \$ 69,594               | \$ 60,259          | \$ 9,335 | 15%      |
| Percentage of net sales                      | 3.1%                    | 3.3%               | (0.2)%   |          |

The increase in selling, general and administrative expenses included \$2.6 million of corporate payroll and benefits to support growth, \$2.4 million of advertising expense, \$2.3 million of secondary offering expenses including related payroll taxes, \$2.0 million of corporate bonus, \$1.4 million of regional expenses due to increased store count and expansion into new regions. These increases were partially offset by a \$3.2 million IPO bonus expense in the prior year. Selling, general and administrative expenses decreased as a percentage of net sales due to leverage in corporate expenses and partially offset by higher advertising expense due to expansion into new markets.

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### ***Store pre-opening costs***

Store pre-opening costs were \$7.1 million for the thirty-nine weeks ended September 28, 2014 and \$5.3 million for the thirty-nine weeks ended September 29, 2013. Store pre-opening costs in the thirty-nine weeks ended September 28, 2014 included \$6.8 million related to opening 24 stores and relocating one store during that period and \$0.3 million associated with stores opening after September 28, 2014. Store pre-opening costs in the thirty-nine weeks ended September 29, 2013 included \$5.3 million related to opening 19 stores during that period.

### ***Store closure and exit costs***

Store closure and exit costs for the thirty-nine weeks ended September 28, 2014 included costs related to the relocation of one store, a \$1.2 million favorable adjustment to reserves for settlement with landlord recorded during the thirteen weeks ended September 28, 2014, offset by changes in reserves for stores and facilities already closed and ongoing expenses related to prior closures. Additionally, we determined that we should have been recording accretion expense for store closure reserves and liability for certain occupancy costs. We made a correcting entry of \$0.9 million to adjust the liability for closed stores to include such accretion and liability for certain occupancy costs for prior periods. The effect of this entry was not material to any period. Store closure and exit costs for the thirty-nine weeks ended September 29, 2013 consisted primarily of costs to close a former Sunflower warehouse and adjustments to sublease estimates for stores and facilities already closed.

### ***Interest expense***

Interest expense decreased to \$19.1 million for the thirty-nine weeks ended September 28, 2014 from \$30.3 million for the thirty-nine weeks ended September 29, 2013. The decrease in interest expense is due to the lower principal balance of our Term Loan, the repayment of higher interest debt in the April 2013 Refinancing, the repayment of the senior subordinated notes and the interest rate reduction under our Credit Facility in conjunction with our IPO.

### ***Loss on extinguishment of debt***

In the thirty-nine weeks ended September 28, 2014, we made a voluntary principal payment of \$50.0 million and wrote-off \$1.1 million of deferred financing costs and original issue discount related to that portion of the Term Loan.

In the thirty-nine weeks ended September 29, 2013, we recorded a loss on extinguishment of debt totaling \$17.2 million related to the write-off of deferred financing costs and issue discount. These write-offs included \$9.0 million related to the August 2013 pay down of debt using proceeds from our IPO and \$8.2 million related to the April 2013 refinancing. Additionally, loss on extinguishment of debt includes \$0.5 million related to the renewal of a financing lease.

### ***Income tax provision***

Income tax provision increased to \$57.1 million for the thirty-nine weeks ended September 28, 2014 from \$27.2 million for the thirty-nine weeks ended September 29, 2013, primarily related to an increase in income before income taxes. Our effective income tax rate decreased to 38.9% in the thirty-nine weeks ended September 28, 2014 from 39.3% in the thirty-nine weeks ended September 29, 2013 due to an increase in the enhanced charitable food contribution.

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*Net income*

|                         | Thirty-Nine weeks ended |                    |           |          |
|-------------------------|-------------------------|--------------------|-----------|----------|
|                         | September 28, 2014      | September 29, 2013 | Change    | % Change |
| Net income              | \$ 89,949               | \$ 42,046          | \$ 47,903 | 114%     |
| Percentage of net sales | 4.0%                    | 2.3%               | 1.7%      |          |

Net income growth was attributable to strong business performance driven by comparable store sales growth and resulting operating leverage, strong performance of new stores opened, lower loss on extinguishment of debt and reduced interest expense.

**Table of Contents****Liquidity and Capital Resources**

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

|                                                 | Thirty-Nine weeks ended |                    |
|-------------------------------------------------|-------------------------|--------------------|
|                                                 | September 28, 2014      | September 29, 2013 |
| Cash and cash equivalents at end of period      | \$ 118,447              | \$ 91,735          |
| Cash provided by operating activities           | \$ 151,301              | \$ 138,304         |
| Cash used in investing activities               | \$ (95,867)             | \$ (74,603)        |
| Cash provided by (used in) financing activities | \$ (14,639)             | \$ (39,177)        |

Since inception, we have financed our operations primarily through cash generated from our operations, sales of our equity and borrowings under our current and former credit facilities. Our primary uses of cash are for purchases of inventory, operating expenses, capital expenditures primarily for opening new stores, remodel and maintenance capital expenditures, and debt service. We believe that our existing cash and cash equivalents, and cash anticipated to be generated by operations will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including new store openings, remodel and maintenance capital expenditures at existing stores, store initiatives and other corporate capital expenditures and activities. Our cash and cash equivalents position benefits from the fact that we generally collect cash from sales to customers the same day or, in the case of credit or debit card transactions, within days from the related sale. In the event that additional financing is required from outside sources, we may not be able to raise it on terms acceptable to us or at all. If we are unable to raise additional capital when desired, our business, results of operations and financial condition would be adversely affected.

***Operating Activities***

Net cash provided by operating activities increased \$13.0 million to \$151.3 million for the thirty-nine weeks ended September 28, 2014 compared to \$138.3 million for the thirty-nine weeks ended September 29, 2013. The thirty-nine weeks ended September 28, 2014 includes the impact of stores opened since September 29, 2013. In addition to the increase in the number of stores we operate, we leveraged occupancy, buying, utilities and fixed direct store expenses with higher comparable store sales growth. We also experienced a decrease in interest expense due to refinancing our long-term debt, reduction in balances from a payoff made with IPO proceeds and other unscheduled voluntary repayments and lower interest rate, including a 0.5% lower rate due to our IPO.

***Investing Activities***

Net cash used in investing activities was \$95.9 million for the thirty-nine weeks ended September 28, 2014 compared to \$74.6 million for the thirty-nine weeks ended September 29, 2013. The increase in cash used for investing activities is primarily related to timing of payments on capital expenditures for new store openings, store remodels and maintenance capital expenditures.

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

We expect capital expenditures of approximately \$110 million in fiscal 2014, net of estimated landlord tenant improvement allowances, primarily to fund investments in new stores, remodels, maintenance capital expenditures and corporate capital expenditures. We expect to fund our capital expenditures with cash on hand, cash generated from operating activities and, if required, borrowings under our Credit Facility.

**Table of Contents****Financing Activities**

Net cash used by financing activities was \$14.6 million for the thirty-nine weeks ended September 28, 2014 compared to cash used in financing activities of \$39.2 million for the thirty-nine weeks ended September 29, 2013. The decrease in cash used by financing activities of \$24.6 million is related to \$295.9 million of payments to stockholders and optionholders in 2013, \$35.0 million in payments on senior subordinated notes in 2013, a \$30.6 million increase of excess tax benefits from the exercise of stock options and payments to optionholders, a \$7.5 million increase in proceeds from the exercise of stock options, a \$4.2 million payment of IPO costs in 2013, a \$1.7 million decrease in payments, including a \$50.0 million voluntary payment during the thirteen weeks ended September 28, 2014 on our term loan, net of borrowings, and a \$1.4 million payment of deferred financing costs in 2013. These decreases in cash used by financing activities were offset by \$348.3 million proceeds from the issuance of shares in 2013 and a decrease of \$3.5 million in cash from landlords related to financing lease obligations.

**Long-Term Debt and Credit Facilities**

See Note 6 Long-Term Debt of our unaudited consolidated financial statements for a description of the April 2013 Refinancing and our Credit Facility.

**Contractual Obligations**

We are committed under certain capital leases for the rental of certain buildings and land and certain operating leases for rental of facilities and equipment. These leases expire or become subject to renewal clauses at various dates through 2032.

The following table summarizes our lease obligations as of September 28, 2014, and the effect such obligations are expected to have on our liquidity and cash flow in future periods:

|                                            | Payments Due by Period |                     |                             |            | More<br>Than<br>5 Years |
|--------------------------------------------|------------------------|---------------------|-----------------------------|------------|-------------------------|
|                                            | Total                  | Less Than<br>1 Year | 1-3 Years<br>(in thousands) | 4-5 Years  |                         |
| Capital and financing lease obligations(1) | \$ 156,401             | \$ 15,113           | \$ 30,715                   | \$ 30,614  | \$ 79,960               |
| Operating lease obligations(1)             | 1,101,360              | 83,281              | 194,804                     | 194,852    | 628,423                 |
| Totals                                     | \$ 1,257,761           | \$ 98,394           | \$ 225,519                  | \$ 225,466 | \$ 708,383              |

(1) Represents estimated payments for capital and financing and operating lease obligations as of September 28, 2014. Capital and financing lease obligations and operating lease obligations are presented gross without offset for subtenant rentals. We have subtenant agreements under which we will receive \$1.2 million for the period of less than one year, \$2.1 million for years one to three, \$1.4 million for years four to five, and \$2.1 million for the period beyond five years.

We have other contractual commitments and debt, which were presented under Contractual Obligations in our Annual Report on Form 10-K for the fiscal year ended December 29, 2013, and for which there have not been material changes since that filing.

**Off-Balance Sheet Arrangements**

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

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### **Impact of Inflation**

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

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

### **Seasonality**

Our business is subject to modest seasonality. Our average weekly sales fluctuate throughout the year and are typically highest in the first half of the fiscal year. Produce, which contributed approximately 26% of our net sales for the thirty-nine weeks ended September 28, 2014, is generally more available in the first six months of our fiscal year due to the timing of peak growing seasons.

### **Critical Accounting Estimates**

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

There have been no substantial changes to these estimates or the policies related to them during the thirty-nine weeks ended September 28, 2014. For a full discussion of these estimates and policies, see **Critical Accounting Estimates** in Item 7 of our Annual Report on Form 10-K for the fiscal year ended December 29, 2013.

### **Recently Issued Accounting Pronouncements**

See Note 2 to our accompanying unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q.

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

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

As described in Note 6, **Long-Term Debt** to our consolidated financial statements located elsewhere in this Quarterly Report on Form 10-Q, we have a Term Loan that bears interest at a rate based in part on LIBOR, the Federal Funds Rate, the Eurodollar Rate or the prime rate, depending on our consolidated leverage ratio. Accordingly, we are exposed to fluctuations in interest rates. Based on the \$263.0 million principal outstanding under our Term Loan as of September 28, 2014, each hundred basis point change in LIBOR, once LIBOR exceeds the LIBOR floor under our loan of 1.00%, would result in a change in interest expense by \$2.6 million annually.

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

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### **Item 4. Controls and Procedures.**

#### ***Evaluation of Disclosure Controls and Procedures***

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures under the Exchange Act as of September 28, 2014, the end of the period covered by this Quarterly Report on Form 10-Q. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were not effective because, as of September 28, 2014, we continued to have a material weakness related to our internal controls with respect to costing of non-perishable inventories, which we are currently addressing through the implementation of the new automated system for the calculation of inventory cost on a per unit basis. The Company is currently testing the new system and the ongoing effectiveness of the new controls. The material weakness cannot be considered remediated until the applicable remedial controls operate for a sufficient period of time and management has concluded, through testing, that these controls are operating effectively.

#### ***Changes in Internal Control Over Financial Reporting***

During the quarterly period ended September 28, 2014, there were no changes in our internal controls over financial reporting that materially affected, or were reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings.**

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

**Item 1A. Risk Factors.**

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

There have been no material changes to the Risk Factors described under Part I Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 29, 2013.

**Item 6. Exhibits.**

| Exhibit Number | Description                                                                                                                                      |
|----------------|--------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1           | Amended and Restated Nature's Best Distribution Agreement, dated as of August 13, 2014                                                           |
| 31.1           | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                               |
| 31.2           | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                               |
| 32.1           | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2           | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101.INS        | XBRL Instance Document                                                                                                                           |
| 101.SCH        | XBRL Taxonomy Extension Schema Document                                                                                                          |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document                                                                                            |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document                                                                                             |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document                                                                                                  |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document                                                                                           |

Portions of this exhibit (indicated by asterisks) have been omitted pursuant to a request for confidential treatment submitted separately to the Securities and Exchange Commission pursuant to Rule 406 under the Securities Act.

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**SIGNATURES**

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

**SPROUTS FARMERS MARKET, INC.**

Date: November 6, 2014

By: */s/ Amin N. Maredia*  
Name: Amin N. Maredia  
Title: Chief Financial Officer  
(Principal Financial Officer)

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**EXHIBIT INDEX**

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