

Natural Grocers by Vitamin Cottage, Inc.
Form 10-Q
May 01, 2014
[Table of Contents](#)

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

Form 10-Q

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

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2014;

OR

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

COMMISSION FILE NUMBER: 001-35608

Natural Grocers by Vitamin Cottage, Inc.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

45-5034161

(I.R.S. Employer
Identification Number)

**12612 West Alameda Parkway
Lakewood, Colorado**

(Address of principal executive offices)

80228

(Zip code)

(303) 986-4600

(Registrant's telephone number, including area code)

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

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

The number of shares of the registrant's common stock, \$0.001 par value, outstanding as of April 29, 2014 was 22,476,986.

Table of Contents

Natural Grocers by Vitamin Cottage, Inc.
Quarterly Report on Form 10-Q
For the Quarterly Period Ended March 31, 2014

Table of Contents

| | Page Number |
|---|------------------------|
| <u>PART I. Financial Information</u> | |
| <u>Item 1.</u> | |
| <u>Financial Statements</u> | |
| <u>Consolidated Balance Sheets as of March 31, 2014 and September 30, 2013 (unaudited)</u> | 3 |
| <u>Consolidated Statements of Income for the three and six months ended March 31, 2014 and 2013 (unaudited)</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income for the three and six months ended March 31, 2014 and 2013 (unaudited)</u> | 5 |
| <u>Consolidated Statements of Cash Flows for the six months ended March 31, 2014 and 2013 (unaudited)</u> | 6 |
| <u>Notes to Unaudited Interim Consolidated Financial Statements</u> | 7 |
| <u>Item 2.</u> | |
| <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| <u>Item 3.</u> | |
| <u>Quantitative and Qualitative Disclosures About Market Risk</u> | 25 |
| <u>Item 4.</u> | |
| <u>Controls and Procedures</u> | 25 |
| <u>PART II. Other Information</u> | |
| <u>Item 1.</u> | |
| <u>Legal Proceedings</u> | 25 |
| <u>Item 1A.</u> | |
| <u>Risk Factors</u> | 25 |
| <u>Item 6.</u> | |
| <u>Exhibits</u> | 26 |
| <u>SIGNATURES</u> | 27 |
| <u>EXHIBIT INDEX</u> | 28 |

Table of Contents

Except where the context otherwise requires or where otherwise indicated, all references herein to we, us, our, Natural Grocers, and the Company refer collectively to Natural Grocers by Vitamin Cottage, Inc. and its consolidated subsidiaries.

Forward-Looking Statements

This report on Form 10-Q includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 in addition to historical information. These forward-looking statements are included throughout this report on Form 10-Q, including in the section entitled Management's Discussion and Analysis of Financial Condition and Results of Operations. All statements that are not statements of historical fact, including those that relate to matters such as our industry, business strategy, goals and expectations concerning our market position, future operations, margins, profitability, capital expenditures, liquidity and capital resources and other financial and operating information are forward-looking statements. We have used the words anticipate, assume, believe, continue, could, estimate, expect, plan, potential, predict, project, future and similar terms and phrases to identify forward-looking statements in this report on Form 10-Q.

The forward-looking statements contained in this report on Form 10-Q are based on management's current expectations and are subject to uncertainty and changes in circumstances. We cannot assure you that future developments affecting us will be those that we have anticipated. Actual results may differ materially from these expectations due to changes in global, regional or local political, economic, business, competitive, market, regulatory and other factors, many of which are beyond our control. We believe that these factors include those referenced in Risk Factors in our report on Form 10-K for the year ended September 30, 2013 (our Form 10-K), as amended by Part II, Item 1A of this report on Form 10-Q. Should one or more of these risks or uncertainties materialize, or should any of our assumptions prove incorrect, our actual results may vary in material respects from those projected in these forward-looking statements.

Any forward-looking statement made by us in this report on Form 10-Q speaks only as of the date of this report. Factors or events that could cause our actual results to differ may emerge from time to time, and it is not possible for us to predict all of them. We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future developments or otherwise, except as may be required by any applicable securities laws. You are advised, however, to consult any further disclosures we may make in our future reports to the Securities and Exchange Commission, on our website or otherwise.

Table of Contents**PART I. Financial Information****Item 1. Financial Statements****NATURAL GROCERS BY VITAMIN COTTAGE, INC.****Consolidated Balance Sheets****(Unaudited)***(Dollars in thousands, except per share data)*

| | March 31, 2014 | September 30, 2013 |
|--|-------------------|-----------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 7,814 | 8,132 |
| Restricted cash | | 500 |
| Short term investments available-for-sale securities | 95 | 1,149 |
| Accounts receivable, net | 1,801 | 2,401 |
| Merchandise inventory | 53,090 | 45,472 |
| Prepaid expenses and other current assets | 1,183 | 1,097 |
| Deferred income tax assets | 1,279 | 1,114 |
| Total current assets | 65,262 | 59,865 |
| Property and equipment, net | 108,518 | 98,910 |
| Other assets: | | |
| Deposits and other assets | 740 | 203 |
| Goodwill and other intangible assets, net of accumulated amortization of \$654 and \$654, respectively | 900 | 900 |
| Deferred financing costs, net | 44 | 25 |
| Total other assets | 1,684 | 1,128 |
| Total assets | \$ 175,464 | 159,903 |
| Liabilities and Stockholders Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 34,096 | 28,918 |
| Accrued expenses | 10,713 | 9,306 |
| Capital and financing lease obligations, current portion | 195 | 174 |
| Total current liabilities | 45,004 | 38,398 |
| Long-term liabilities: | | |
| Capital and financing lease obligations, net of current portion | 19,560 | 19,648 |
| Deferred income tax liabilities | 6,606 | 6,877 |
| Deferred rent | 5,373 | 4,731 |
| Leasehold incentives | 6,743 | 5,716 |
| Total long-term liabilities | 38,282 | 36,972 |
| Total liabilities | 83,286 | 75,370 |
| Commitments (Note 12) | | |

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Stockholders' equity:

| | | |
|---|------------|---------|
| Common stock, \$0.001 par value. Authorized 50,000,000 shares, 22,476,986 and 22,441,253 issued and outstanding, respectively | 22 | 22 |
| Additional paid in capital | 54,428 | 53,704 |
| Retained earnings | 37,728 | 30,807 |
| Total stockholders' equity | 92,178 | 84,533 |
| Total liabilities and stockholders' equity | \$ 175,464 | 159,903 |

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents**NATURAL GROCERS BY VITAMIN COTTAGE, INC.****Consolidated Statements of Income****(Unaudited)***(Dollars in thousands, except per share data)*

| | Three months ended March 31, | | Six months ended March 31, | |
|---|---------------------------------|------------|-------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net sales | \$ 130,343 | 106,485 | 250,923 | 202,316 |
| Cost of goods sold and occupancy costs | 91,590 | 74,668 | 176,789 | 142,662 |
| Gross profit | 38,753 | 31,817 | 74,134 | 59,654 |
| Store expenses | 26,877 | 22,163 | 52,050 | 42,366 |
| Administrative expenses | 3,548 | 3,342 | 7,437 | 6,668 |
| Pre-opening and relocation expenses | 1,211 | 796 | 2,100 | 1,315 |
| Operating income | 7,117 | 5,516 | 12,547 | 9,305 |
| Other (expense) income: | | | | |
| Interest expense | (704) | (401) | (1,411) | (656) |
| Other income, net | 1 | 2 | 2 | 4 |
| Total other expense | (703) | (399) | (1,409) | (652) |
| Income before income taxes | 6,414 | 5,117 | 11,138 | 8,653 |
| Provision for income taxes | (2,415) | (1,900) | (4,217) | (3,215) |
| Net income | \$ 3,999 | 3,217 | 6,921 | 5,438 |
| Net income per common share: | | | | |
| Basic | \$ 0.18 | 0.14 | 0.31 | 0.24 |
| Diluted | \$ 0.18 | 0.14 | 0.31 | 0.24 |
| Weighted average common shares outstanding: | | | | |
| Basic | 22,464,941 | 22,393,993 | 22,453,441 | 22,382,969 |
| Diluted | 22,483,753 | 22,441,445 | 22,477,201 | 22,437,183 |

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Consolidated Statements of Comprehensive Income

(Unaudited)

(Dollars in thousands)

| | Three months ended March 31, | | Six months ended March 31, | |
|--|---|-------------|---------------------------------------|-------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 3,999 | 3,217 | 6,921 | 5,438 |
| Other comprehensive income, net of tax: | | | | |
| Unrealized gain on available-for-sale securities, net of tax | | 1 | | 2 |
| Other comprehensive income | | 1 | | 2 |
| Comprehensive income | \$ 3,999 | 3,218 | 6,921 | 5,440 |

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents**NATURAL GROCERS BY VITAMIN COTTAGE, INC.****Consolidated Statements of Cash Flows****(Unaudited)***(Dollars in thousands)*

| | Six months ended March 31, | |
|---|-----------------------------------|-------------|
| | 2014 | 2013 |
| Operating activities: | | |
| Net income | \$ 6,921 | 5,438 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 8,054 | 6,225 |
| Gain on disposal of property and equipment | | (2) |
| Share-based compensation | 263 | 43 |
| Excess tax benefit from share-based compensation | (460) | (211) |
| Deferred income tax (benefit) expense | (437) | 652 |
| Non-cash interest expense | 11 | 31 |
| Interest accrued on investments and amortization of premium | 9 | 12 |
| Other amortization | | 26 |
| Changes in operating assets and liabilities | | |
| Decrease (increase) in: | | |
| Accounts receivable, net | 600 | 272 |
| Income tax receivable | 359 | |
| Merchandise inventory | (7,618) | (4,993) |
| Prepaid expenses and other assets | (981) | (193) |
| Increase (decrease) in: | | |
| Accounts payable | 5,382 | 1,339 |
| Accrued expenses | 1,876 | 2,072 |
| Deferred rent and leasehold incentives | 1,669 | (18) |
| Net cash provided by operating activities | 15,648 | 10,693 |
| Investing activities: | | |
| Acquisition of property and equipment | (17,853) | (17,667) |
| Proceeds from sale of property and equipment | | 2 |
| Purchase of available-for-sale securities | | (426) |
| Proceeds from maturity of available-for-sale securities | 1,045 | 340 |
| Decrease (increase) in restricted cash | 500 | (500) |
| Net cash used in investing activities | (16,308) | (18,251) |
| Financing activities: | | |
| Borrowings under credit facility | 530 | |
| Repayments under credit facility | (530) | |
| Repayments under notes payable, related party | | (128) |
| Capital and financing lease obligations payments | (88) | (33) |
| Excess tax benefit from share-based compensation | 460 | 211 |
| Equity issuance costs | | (268) |
| Credit facility fees paid | (30) | (18) |
| Net cash provided by (used in) financing activities | 342 | (236) |
| Net decrease in cash and cash equivalents | (318) | (7,794) |
| Cash and cash equivalents, beginning of period | 8,132 | 17,291 |
| Cash and cash equivalents, end of period | \$ 7,814 | 9,497 |

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Supplemental disclosures of cash flow information:

| | | | |
|--|----|-------|--------|
| Cash paid for interest | \$ | | 6 |
| Cash paid for interest on capital and financing lease obligations | | 1,392 | 619 |
| Income taxes paid | | 3,656 | 1,948 |
| Supplemental disclosures of non-cash investing and financing activities: | | | |
| Acquisition of property and equipment not yet paid | \$ | 3,341 | 4,087 |
| Property acquired through capital and financing lease obligations | | 14 | 10,523 |

See accompanying notes to unaudited interim consolidated financial statements.

Table of Contents

NATURAL GROCERS BY VITAMIN COTTAGE, INC.

Notes to Unaudited Interim Consolidated Financial Statements

March 31, 2014 and 2013

1. Organization

Nature of Business

Natural Grocers by Vitamin Cottage, Inc. (Natural Grocers or the holding company) and its consolidated subsidiaries (collectively, the Company) operate retail stores that specialize in natural and organic groceries and dietary supplements. The Company typically operates its retail stores under its trademark *Natural Grocers by Vitamin Cottage*® with 81 stores as of March 31, 2014, including 32 stores in Colorado, 13 in Texas, six in Oregon, five each in Kansas and New Mexico, four in Montana, three each in Arizona, Idaho, Nebraska and Oklahoma, two in Wyoming, and one each in Missouri and Utah, as well as a bulk food repackaging facility and distribution center in Colorado. The Company had 72 stores as of September 30, 2013.

2. Basis of Presentation and Summary of Significant Accounting Policies

Consolidated Financial Statements

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial statements and are in the form prescribed by the Securities and Exchange Commission in Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. The information included in this report on Form 10-Q should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto included in the Company's Form 10-K for the year ended September 30, 2013. In the opinion of management, the accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation. Interim results are not necessarily indicative of results for any other interim period or for a full fiscal year. The Company reports its results of operations on a fiscal year ending September 30.

The holding company was incorporated in Delaware on April 9, 2012. The accompanying consolidated financial statements include all the accounts of the Company's wholly owned subsidiaries, Vitamin Cottage Natural Food Markets, Inc. (the operating company), Vitamin Cottage Two Ltd. Liability Company and Natural Systems, LLC. The operating company formed the holding company in order to facilitate the purchase

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of the remaining noncontrolling interest in Boulder Vitamin Cottage Group, LLC and consummation of the Company's initial public offering (IPO) during fiscal year 2012. All significant intercompany balances and transactions have been eliminated in consolidation.

The Company has one reporting segment, natural and organic retail stores. Sales from the Company's natural and organic retail stores are derived from sales of the following products, which are presented as a percentage of sales for the three and six months ended March 31, 2014 and 2013 as follows:

| | Three months ended | | Six months ended | |
|---------------------|--------------------|-------|------------------|-------|
| | March 31, | | March 31, | |
| | 2014 | 2013 | 2014 | 2013 |
| Grocery | 66.1% | 64.4 | 66.3 | 64.2 |
| Dietary supplements | 24.0 | 25.7 | 23.7 | 25.6 |
| Other | 9.9 | 9.9 | 10.0 | 10.2 |
| | 100.0% | 100.0 | 100.0 | 100.0 |

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the balance sheet date and reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Recent Accounting Pronouncements

In February 2013, the Financial Accounting Standards Board, or FASB, issued Accounting Standards Update, or ASU, No. 2013-02 Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. ASU No. 2013-02 supersedes

Table of Contents

the presentation requirements for reclassifications out of accumulated other comprehensive income in both ASU No. 2011-12 and 2011-05. ASU No. 2013-02 requires an entity to disaggregate the total change of each component of other comprehensive income either on the face of the income statement or as a separate disclosure in the notes. Amounts that are not required to be reclassified in their entirety to net income must be cross-referenced to other disclosures that provide additional detail. This update was effective for the Company beginning in the quarter ended December 31, 2013. The adoption of this update did not have a material effect on the Company's consolidated financial statements.

3. Earnings Per Share

Basic earnings per share (EPS) excludes dilution and is computed by dividing net income by the weighted average shares outstanding during the period. Diluted EPS reflects the potential dilution that could occur if the Company's granted but unvested restricted stock units were to vest, resulting in the issuance of common stock that would then share in the earnings of the Company. Presented below are basic and diluted EPS for the three and six months ended March 31, 2014 and 2013, dollars in thousands, except per share data:

| | Three months ended March 31, | | Six months ended March 31, | |
|--|---------------------------------|------------|-------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 3,999 | 3,217 | 6,921 | 5,438 |
| Weighted average common shares outstanding | 22,464,941 | 22,393,993 | 22,453,441 | 22,382,969 |
| Effect of dilutive securities | 18,812 | 47,452 | 23,760 | 54,214 |
| Weighted average common shares outstanding including effect of dilutive securities | 22,483,753 | 22,441,445 | 22,477,201 | 22,437,183 |
| Basic earnings per share | \$ 0.18 | 0.14 | 0.31 | 0.24 |
| Diluted earnings per share | \$ 0.18 | 0.14 | 0.31 | 0.24 |

There were 3,558 non-vested restricted stock units (RSUs) for the three and six months ended March 31, 2014 excluded from the calculation as they are antidilutive. There were 4,856 antidilutive non-vested RSUs for the three and six months ended March 31, 2013.

The Company did not declare any dividends in the three and six months ended March 31, 2014 or 2013.

4. Long-Term Debt*Credit Facility*

The Company has a revolving credit facility. The operating company is the borrower under the credit facility and its obligations under the credit facility are guaranteed by the holding company.

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On December 12, 2013, the Company entered into an amended and restated \$15.0 million credit agreement that, among other things, (i) extended the maturity date of the Company's revolving credit facility by three years to January 31, 2017, (ii) provides the Company with the right to request the issuance of letters of credit under the credit facility up to \$3.0 million, (iii) allows the Company to increase the amount available under the revolving credit facility, up to an additional amount that may not exceed \$10.0 million by obtaining an additional commitment or commitments, (iv) eliminated a requirement for a consolidated earnings before interest, taxes, depreciation and amortization to revenue ratio and (v) amended the unused commitment fee from 0.20% to amounts ranging from 0.15% to 0.35% based on certain conditions.

The Company had no amounts outstanding on the revolving credit facility as of March 31, 2014 and September 30, 2013. During the six months ended March 31, 2014, the Company made and repaid draws on the revolving credit facility. As of March 31, 2014, the Company had an undrawn, issued and outstanding letter of credit of \$0.7 million which was reserved against the amount available for borrowing under the terms of the revolving credit facility. There was an available balance of \$14.3 million and \$15.0 million as of March 31, 2014 and September 30, 2013, respectively, under the revolving credit facility.

As of March 31, 2014 and September 30, 2013, the Company was in compliance with the debt covenants under the credit facility.

Table of Contents*Capital and Financing Lease Obligations*

From time to time, the Company enters into various leases that are included in capital and financing lease obligations. The Company does not record rent expense for these capitalized real estate leases, but rather rental payments under the capital leases are recognized as a reduction of the capital and financing lease obligation and as interest expense (see Note 5).

Interest

The Company incurred gross interest expense of approximately \$0.7 million and approximately \$0.4 million in the three months ended March 31, 2014 and 2013, respectively, and approximately \$1.4 million and approximately \$0.7 million in the six months ended March 31, 2014 and 2013, respectively, related primarily to interest on capital and financing lease obligations. The Company did not capitalize any interest for the three or six months ended March 31, 2014 and 2013, and had insignificant amounts of amortization of deferred financing costs for the three and six months ended March 31, 2014 and 2013.

5. Lease Commitments

Capital and financing lease obligations as of March 31, 2014 and September 30, 2013, are as follows, dollars in thousands:

| | March 31, 2014 | As of September 30, 2013 |
|---|---------------------------|---|
| Capital lease finance obligations, due in monthly installments through fiscal year 2028 | \$ 15,022 | 13,746 |
| Capital lease obligations, due in monthly installments through fiscal year 2028 | 4,733 | 4,792 |
| Capital lease finance obligations for assets under construction, due in monthly installments through fiscal year 2028 | | 1,284 |
| Total capital and financing lease obligations | 19,755 | 19,822 |
| Less current portion | (195) | (174) |
| Total capital and financing lease obligations, net of current portion | \$ 19,560 | 19,648 |

6. Property and Equipment

The Company had the following property and equipment balances as of March 31, 2014 and September 30, 2013, dollars in thousands:

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| | Useful lives (in years) | As of | |
|--|----------------------------|-------------------|-----------------------|
| | | March 31, 2014 | September 30, 2013 |
| Construction in process | n/a | \$ 3,835 | 5,421 |
| Capitalized real estate leases for build-to-suit stores, including unamortized land of \$617 and \$617, respectively | 40 | 17,107 | 15,774 |
| Capitalized real estate leases | 15 | 4,866 | 4,866 |
| Land improvements | 5 - 15 | 1,000 | 1,000 |
| Leasehold and building improvements | 2 - 20 | 68,179 | 59,058 |
| Fixtures and equipment | 5 - 7 | 64,037 | 56,459 |
| Computer hardware and software | 3 - 5 | 9,468 | 8,252 |
| | | 168,492 | 150,830 |
| Less accumulated depreciation and amortization | | (59,974) | (51,920) |
| Property and equipment, net | | \$ 108,518 | 98,910 |

As of March 31, 2014 and September 30, 2013, respectively, capitalized real estate leases for build-to-suit stores includes the assets for the Company's buildings for build-to-suit stores under capital lease finance obligations, and capitalized real estate leases includes assets for the Company's buildings under capital leases (see Note 5).

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Table of Contents

Construction in process includes zero and approximately \$1.3 million as of March 31, 2014 and September 30, 2013, respectively, related to construction costs for build-to-suit leases in process for which the Company was deemed the owner during the construction period.

Depreciation and amortization expense for the three and six months ended March 31, 2014 and 2013 is summarized as follows, dollars in thousands:

| | Three months ended March 31, | | Six months ended March 31, | |
|--|---------------------------------|-------|-------------------------------|-------|
| | 2014 | 2013 | 2014 | 2013 |
| Depreciation and amortization expense included in cost of goods sold and occupancy costs | \$ 190 | 183 | 376 | 356 |
| Depreciation and amortization expense included in store expenses | 3,799 | 2,949 | 7,442 | 5,650 |
| Depreciation and amortization expense included in administrative expenses | 127 | 101 | 236 | 219 |
| Total depreciation and amortization expense | \$ 4,116 | 3,233 | 8,054 | 6,225 |

7. Supplementary Balance Sheet Information

Restricted Cash

As of September 30, 2013, the Company held \$0.5 million in restricted cash which represented cash that was pledged as collateral for a standby letter of credit related to the Company's workers' compensation insurance. As of March 31, 2014, the Company had released the restricted cash balance which existed as of September 30, 2013, and had no restricted cash balance outstanding.

Accrued Expenses

The composition of accrued expenses is summarized as follows as of March 31, 2014 and September 30, 2013, dollars in thousands:

| | March 31, 2014 | As of September 30, 2013 |
|---|-------------------|--------------------------------|
| Payroll and employee-related expenses | \$ 5,709 | 5,247 |
| Accrued income, property, sales and use tax payable | 3,018 | 2,686 |
| Deferred revenue related to gift card sales | 728 | 625 |
| Other | 1,258 | 748 |
| Total accrued expenses | \$ 10,713 | 9,306 |

8. Investments

The Company had available-for-sale securities consisting of certificates of deposit totaling approximately \$0.1 million as of March 31, 2014, which were classified as short-term. The Company had available-for-sale securities generally consisting of certificates of deposit, corporate bonds and municipal bonds of approximately \$1.1 million as of September 30, 2013, which were classified as short-term. At March 31, 2014 and September 30, 2013, the average maturities of the Company's short-term investments were approximately one month and approximately five months, respectively. There was no other-than-temporary impairment on available-for-sale securities as of March 31, 2014 or September 30, 2013.

During the three and six months ended March 31, 2014 and 2013, the Company recorded insignificant amounts of interest income and expense relating to amortized premiums paid.

9. Fair Value Measurements

The Company records its financial assets and liabilities at fair value in accordance with the framework for measuring fair value in authoritative guidance. The framework establishes a fair value hierarchy that distinguishes between assumptions based on market data (observable inputs) and the Company's own assumptions (unobservable inputs). The three levels are defined as follows:

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Table of Contents

| | |
|---------|--|
| Level 1 | Inputs are unadjusted quoted prices for identical assets or liabilities in active markets; |
| Level 2 | Inputs include quoted prices for similar assets or liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and |
| Level 3 | Inputs are unobservable and are considered significant to the fair value measurement. |

Non-financial assets, such as goodwill and long-lived assets, are accounted for at fair value, if determined to be impaired, on a non-recurring basis. These items are tested for impairment on the occurrence of a triggering event or in the case of goodwill, at least on an annual basis.

The carrying amounts of financial instruments not included in the table below, including cash and cash equivalents, restricted cash, accounts receivable, accounts payable and other accrued expenses, approximate fair value because of the short maturity of those instruments.

As of March 31, 2014 and September 30, 2013, the Company had the following financial assets and liabilities that were subject to fair value measurements according to the fair value hierarchy, dollars in thousands:

| | Fair Value Hierarchy Level | As of | | | |
|--|----------------------------------|--------------------|--------------------|--------------------|------------|
| | | March 31, 2014 | September 30, 2013 | | |
| | | Carrying Amount | Fair Value | Carrying Amount | Fair Value |
| Cash and cash equivalents: | | | | | |
| Money market fund | 1 | \$ | | 501 | 501 |
| Investments available-for-sale securities: | | | | | |
| Certificates of deposit | 2 | 95 | 95 | 585 | 585 |
| Corporate bonds | 2 | | | 376 | 376 |
| Municipal bonds | 2 | | | 188 | 188 |

The money market fund and available-for-sale securities are carried at fair value. For debt securities for which quoted market prices are not available, the fair value is determined using an income approach valuation technique that considers, among other things, rates currently observed in publicly traded debt markets for debt of similar terms to companies with comparable credit risk. During the three and six months ended March 31, 2014, the Company made no purchases of available-for-sale securities. During the three and six months ended March 31, 2013, the Company made purchases of \$0.2 million and \$0.4 million, respectively, of available-for-sale securities. During the three and six months ended March 31, 2014, the Company had \$1.0 million and \$1.0 million of maturities of available-for-sale securities, respectively. During the three and six months ended March 31, 2013, the Company had \$0.3 million and \$0.3 million of maturities of available-for-sale securities, respectively. During the three and six months ended March 31, 2014 and 2013, and for the fiscal year ended September 30, 2013, there were no transfers between levels and the Company had no Level 3 assets. See Note 8 for additional disclosures.

10. Share-based Compensation

The Company adopted an Omnibus Incentive Plan (the Plan) on July 17, 2012. RSUs granted pursuant to the Plan, if they vest, will be settled in shares of the Company's common stock. Changes in non-vested RSUs outstanding under the Plan as of March 31, 2014 were as follows:

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| | RSUs | Weighted average grant date fair value |
|-------------------------------------|----------|---|
| Non-vested as of September 30, 2013 | 86,053 | \$ 21.80 |
| Granted | 3,558 | 42.16 |
| Forfeited | (556) | 34.07 |
| Vested | (35,733) | 4.60 |
| Non-vested as of March 31, 2014 | 53,322 | 34.56 |

Each independent member of the Company's Board of Directors is granted a number of RSUs under the Plan each year equal to the number of shares of common stock having a value of \$50,000 based on the closing price of common stock on the New York Stock Exchange (NYSE) on the date of grant. All of these RSUs are granted on the date of the Company's annual meeting of stockholders or, in the case of a mid-year appointment, a pro rata portion is granted at the time of appointment. In either case, the RSUs vest over a twelve month period and are expensed straight-line over that period. The Company held its annual meeting of stockholders on March 5, 2014, and each independent member of the Company's Board of Directors received awards based on the

Table of Contents

closing price of common stock on the NYSE on that date. The RSUs granted to the independent members of the Board of Directors at the Company's annual meeting on March 6, 2013 vested on March 6, 2014.

The RSU grant to the Chief Financial Officer (CFO Award) under the Plan was in accordance with the terms of her employment agreement that was signed in June 2008, which stated she was entitled to receive a grant of RSUs equal to 1.2% of the fully diluted shares of the Company in connection with an IPO. Two-thirds of the CFO Award vested immediately upon completion of the IPO and was settled in a combination of common stock and cash. The remaining one-third was settled 100% in shares of common stock and vested, in three equal parts over a six, 12 and 18 month period following the IPO. In January 2014, which was 18 months after the IPO, the final portion vested.

The Company recorded total share-based compensation expense before income taxes of approximately \$0.2 million and \$0.3 million in the three and six months ended March 31, 2014, respectively, and recorded less than \$0.1 million in each of the three and six months ended March 31, 2013, respectively. The share-based compensation expense is included in cost of goods sold and occupancy expenses, store expenses or administrative expenses in the consolidated statements of income consistent with the manner in which the applicable officer, board member or key employee's compensation expense is recorded. As of March 31, 2014, there was approximately \$1.5 million of unrecognized share-based compensation expense related to non-vested RSUs net of estimated forfeitures, which the Company anticipates will be recognized over a weighted average period of approximately three years.

11. Related Party Transactions

The Company has ongoing relationships with related entities as noted below:

Isely Family Land Trust LLC: The Company has one operating lease for a store location with the Isely Family Land Trust LLC (Land Trust). The Land Trust is owned by the Isely Children's Trust and by the Margaret A. Isely Family Trust. Rent paid to the Land Trust was approximately \$0.1 million for each of the three months ended March 31, 2014 and 2013. Rent paid to the Land Trust was approximately \$0.2 million for each of the six months ended March 31, 2014 and 2013.

Chalet Properties, LLC: The Company has seven operating leases with Chalet Properties, LLC (Chalet). Chalet is owned by the Company's four non-independent board members: Kemper Isely, Zephyr Isely, Heather Isely and Elizabeth Isely, and other related family members. Rent paid to Chalet was approximately \$0.3 million for each of the three months ended March 31, 2014 and 2013. Rent paid to Chalet was approximately \$0.6 million for each of the six months ended March 31, 2014 and 2013.

12. Commitments and Contingencies

Legal

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The Company is periodically involved in various legal proceedings that are incidental to the conduct of its business, including but not limited to employment discrimination claims, customer injury claims and investigations. When the potential liability from a matter can be estimated and the loss is considered probable, the Company records the estimated loss. Due to uncertainties related to the resolution of lawsuits, investigations and claims, the ultimate outcome may differ from the estimates. Although the Company cannot predict with certainty the ultimate resolution of any lawsuits, investigations and claims asserted against it, management does not believe any currently pending legal proceeding to which the Company is a party will have a material adverse effect on its business, prospects, financial condition, cash flows or results of operations.

Table of Contents

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) should be read in conjunction with our unaudited consolidated financial statements and notes thereto included elsewhere in this report on Form 10-Q and with our Form 10-K. This discussion and analysis contains forward-looking statements. Refer to *Forward-Looking Statements* at the beginning of this report for an explanation of these types of statements. All references to a fiscal year refer to a year beginning on October 1 of the previous year, and ending on September 30 of such year (for example fiscal year 2014 refers to the year from October 1, 2013 to September 30, 2014). Summarized numbers included in this section, and corresponding percentage or basis point changes may not sum due to the effects of rounding.

Company Overview

We operate natural and organic grocery and dietary supplement stores that are focused on providing high quality products at affordable prices, exceptional customer service, nutrition education and community outreach. We believe we have been at the forefront of the natural and organic foods movement since our founding. We are headquartered in Lakewood, Colorado, and as of March 31, 2014, we operated 81 stores in 13 states, including Colorado, Arizona, Idaho, Kansas, Missouri, Montana, Nebraska, New Mexico, Oklahoma, Oregon, Texas, Utah and Wyoming, as well as a bulk food repackaging facility and distribution center in Colorado.

We offer a variety of natural and organic groceries and dietary supplements that meet our strict quality standards. We regularly review and update these standards. During the three months ended March 31, 2014, for example, we updated our dairy standards and, as a result, plan by April 2015 to sell only pasture-raised, non-confinement dairy products.

The size of our stores varies from 5,000 to 16,000 selling square feet. During the twelve months ended March 31, 2014, our new stores averaged approximately 11,500 selling square feet.

The growth in the organic and natural foods industry and growing consumer interest in health and nutrition has enabled us to continue to open new stores and enter new markets. During the five fiscal years ended September 30, 2013, we grew at a compound annual growth rate of 21.7%. In fiscal year 2013, we opened 13 new stores, and we currently plan to open 15 new stores in fiscal year 2014, nine of which we opened during the six months ended March 31, 2014. Since March 31, 2014 and as of the date of this report, we have opened two additional new store locations, signed leases for the remaining four new store locations expected to open in the remainder of fiscal year 2014 in Kansas, Oklahoma, Oregon and Washington, and have signed leases for four new store locations expected to open in fiscal year 2015 in Colorado, Kansas, Nevada and Oklahoma. Additionally, we completed the remodel of one existing store location in the six months ended March 31, 2014 and plan to remodel one additional existing store in fiscal year 2014.

Performance Highlights

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Key highlights of our recent performance are discussed briefly below and are discussed in further detail throughout this MD&A. Key financial metrics, including, but not limited to, comparable store sales, daily average comparable store sales, mature store sales and daily average mature store sales are defined under the caption Key Financial Metrics in Our Business, presented later in this MD&A.

- *Net sales.* Net sales were \$130.3 million for the three months ended March 31, 2014, which is an increase of \$23.9 million, or 22.4%, compared to net sales of \$106.5 million for the three months ended March 31, 2013. We reported net sales of \$250.9 million for the six months ended March 31, 2014, which is an increase of \$48.6 million, or 24.0%, compared to net sales of \$202.3 million for the six months ended March 31, 2013.
- *Comparable store sales.* Comparable store sales for the three and six months ended March 31, 2014 increased 6.9% and 8.7%, respectively, over the three and six months ended March 31, 2013.
- *Daily average comparable store sales.* Daily average comparable store sales, which removes the effect of the additional one selling day for the occurrence of Easter in March of 2013, increased 5.7% and 8.1%, respectively in the three and six months ended March 31, 2014 over the three and six months ended March 31, 2013.
- *Mature store sales.* Mature store sales for the three and six months ended March 31, 2014 increased 4.9% and 5.9%, respectively, over the three and six months ended March 31, 2013.
- *Daily average mature store sales.* Daily average mature store sales, which removes the effect of the additional one selling day for the occurrence of Easter in March of 2013, increased 3.7% and 5.3%, respectively, in the three and six months ended

Table of Contents

March 31, 2014 over the three and six months ended March 31, 2013.

- *Net income.* Net income was \$4.0 million for the three months ended March 31, 2014, which increased \$0.8 million, or 24.3%, when compared to net income of \$3.2 million for the three months ended March 31, 2013. We reported net income of \$6.9 million for the six months ended March 31, 2014, which increased \$1.5 million, or 27.3%, when compared to net income of \$5.4 million for the six months ended March 31, 2013.
- *EBITDA.* Earnings before interest, taxes, depreciation and amortization (EBITDA) was \$11.2 million in the three months ended March 31, 2014, which increased \$2.5 million, or 28.4%, from \$8.8 million in the three months ended March 31, 2013. We generated EBITDA of \$20.6 million in the six months ended March 31, 2014, which increased \$5.1 million, or 32.6%, from \$15.5 million in the six months ended March 31, 2013. EBITDA is not a measure of financial performance under GAAP. Refer to the end of this MD&A for a definition of EBITDA and a reconciliation of net income to EBITDA.
- *Liquidity.* As of March 31, 2014, cash and cash equivalents was \$7.8 million, available-for-sale securities, consisting of certificates of deposit, was \$0.1 million, and there was \$14.3 million available under our \$15.0 million amended and restated revolving credit facility. As of March 31, 2014, the Company had an outstanding letter of credit of \$0.7 million which was reserved against the amount available for borrowing under the terms of our revolving credit facility. The Company had no amounts outstanding on the revolving credit facility as of March 31, 2014.
- *New store growth.* We opened five new stores during the three months ended March 31, 2014, and opened nine new stores during the six months ended March 31, 2014. We operated a total of 81 stores as of March 31, 2014. We plan to open a total of 15 new stores in fiscal year 2014, which will result in an annual new store growth rate of 20.8% for fiscal year 2014 compared to fiscal year 2013.

Industry Trends and Economics

We have identified the following recent trends and factors that have impacted and may continue to impact our results of operations and financial condition:

- *Opportunities in the growing natural and organic grocery and dietary supplements industry.* Our industry, which includes organic and natural foods and dietary supplements, continues to experience growth driven primarily by increased public interest in health and nutrition. Capitalizing on this opportunity, we continued to open new stores and markets. As we open new stores, our results of operations have been and may continue to be materially adversely affected based on the timing and number of new stores we open, their initial sales and new lease costs. The length of time it takes for a new store to become profitable can vary depending on a number of factors including location, competition, a new market versus an existing market, the strength of store management and general economic conditions. Once a new store is open, it typically grows at a faster rate than mature stores for several years after its opening date. Mature stores are stores that have been open for any part of five fiscal years or longer.

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As we expand across the U.S. and enter markets where consumers may not be as familiar with our brand, we seek to secure prime real estate locations for our stores to establish greater visibility with consumers in those markets. This strategy has resulted in higher lease costs, and we anticipate these increased costs continuing into the foreseeable future. Our financial results for the three and six months ended March 31, 2014 reflect the effects of these factors, and we anticipate future periods will be impacted likewise.

- *Impact of broader economic trends.* The grocery industry and our sales are affected by general economic conditions, including, but not limited to, consumer spending, economic conditions, the level of disposable consumer income, consumer debt, interest rates, the price of commodities, the political environment and consumer confidence.

Outlook

We believe there are several key factors that have contributed to our success and will enable us to continue to expand profitably and increase our comparable store sales, including a loyal customer base, increasing basket size, growing consumer interest in nutrition and wellness, a differentiated shopping experience that focuses on customer service, nutrition education and a shopper friendly retail environment, and our focus on high quality, affordable natural and organic groceries and dietary supplements.

We plan for the foreseeable future to continue opening new stores and entering new markets at or above recent levels of growth. During the past few years, we have successfully expanded our infrastructure to enable us to support our continued growth. This has included successfully implementing our enterprise resource planning system, hiring key personnel and developing efficient,

Table of Contents

effective new store opening, construction and operations processes and relocating and expanding our bulk food repackaging facility and distribution center in September 2012. We will complete the implementation of a human resources information and learning management system in the third quarter of fiscal year 2014 which we believe will allow us to more efficiently and effectively onboard and train our employees at all locations.

We believe there are attractive opportunities for us to continue to expand our store base and focus on increasing comparable store sales. As we continue to expand our store base, we believe there are opportunities for increased leverage in fixed costs, such as administrative expenses, as well as increased economies of scale in sourcing products. However, due to our commitment to providing high-quality products at affordable prices, such sourcing economies may not be reflected in our gross margin in the near term. Additionally, higher fixed costs of our bulk food repackaging facility and distribution center resulting from the September 2012 relocation and expansion may not be offset by retail price changes or volume increases in the near term.

Our operating results may be affected by a variety of internal and external factors and trends described more fully in the section Risk Factors contained in our Form 10-K, as amended by Part II, Item 1A of this report on Form 10-Q.

Key Financial Metrics in Our Business

In assessing our performance, we consider a variety of performance and financial measures. The key measures are as follows:

Net sales

Our net sales are comprised of gross sales net of discounts, in-house coupons, returns and allowances. In comparing net sales between periods we monitor the following:

- *Change in comparable store sales.* We begin to include sales from a store in comparable store sales on the first day of the thirteenth full month following the store's opening. We monitor the percentage change in comparable store sales by comparing sales from all stores in our comparable store base for a reporting period against sales from the same stores for the same number of operating months in the comparable reporting period of the prior year. When a store that is included in comparable store sales is remodeled or relocated, we continue to consider sales from that store to be comparable store sales. Our comparable store sales data may not be presented on the same basis as our competitors. We use the term *new stores* to refer to stores that have been open for less than thirteen months.
- *Change in daily average comparable store sales.* Daily average comparable store sales are comparable store sales divided by the number of selling days in each period. We use this metric to remove the effect of differences in the number of selling days we are open during the comparable periods.

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- *Change in mature store sales.* We begin to include sales from a store in mature store sales after the store has been open for any part of five fiscal years (for example, our mature stores for fiscal year 2014 are stores that opened during or before fiscal year 2009). We monitor the percentage change in mature store sales by comparing sales from all stores in our mature store base for a reporting period against sales from the same stores for the same number of operating months in the comparable reporting period of the prior year. When a store that is included in mature store sales is remodeled or relocated, we continue to consider sales from that store to be mature store sales. Our mature store sales data may not be presented on the same basis as our competitors.
- *Change in daily average mature store sales.* Daily average mature store sales are mature store sales divided by the number of selling days in each period. We use this metric to remove the effect of differences in the number of selling days during the comparable periods.
- *Transaction count.* Transaction count represents the number of transactions reported at our stores over such period and includes transactions that are voided, return transactions and exchange transactions.
- *Average transaction size.* Average transaction size is calculated by dividing net sales by transaction count for a given time period. We use this metric to track the trends in average dollars spent in our stores per customer transaction.

Cost of goods sold and occupancy costs

Our cost of goods sold and occupancy costs include the cost of inventory sold during the period (net of discounts and allowances), shipping and handling costs, distribution and supply chain costs (including the costs of our bulk food repackaging facility), buying costs, shrink and store occupancy costs. Store occupancy costs include rent, common area maintenance and real estate

Table of Contents

taxes. Depreciation expense included in cost of goods sold relates to depreciation of assets directly used at our bulk food repackaging facility. The components of our cost of goods sold and occupancy costs may not be identical to those of our competitors, and as a result, our cost of goods sold and occupancy costs data included in this report on Form 10-Q may not be identical to those of our competitors, and may not be comparable to similar data made available by our competitors. Occupancy costs as a percentage of sales typically decrease as new stores mature and increase sales. We do not record straight-line rent expense in cost of goods sold and occupancy costs for the leases classified as capital and financing lease obligations, but rather rent payments are recognized as a reduction of the related obligations and as interest expense. Additionally, depreciation expense related to the capitalized asset is recorded in store expenses.

Gross profit and gross margin

Gross profit is equal to our net sales less our cost of goods sold and occupancy costs. Gross margin is gross profit as a percentage of sales. Gross margin is impacted by changes in retail prices, product costs, occupancy costs, and the mix of products sold, as well as the rate at which we open new stores.

Store expenses

Store expenses consist of store level expenses, such as salary and benefits, share-based compensation, supplies, utilities, depreciation, advertising, bank credit card charges and other related costs associated with operations and purchasing support. Depreciation expense included in store expenses relates to depreciation for assets directly used at the stores including depreciation on capitalized real estate leases, land improvements, leasehold improvements, fixtures and equipment and computer hardware and software. Additionally, store expenses include any gain or loss recorded on the disposal of fixed assets, primarily related to store relocations. The majority of store expenses are comprised of salary related expenses which we closely manage and which trend closely with sales. Labor related expenses as a percentage of sales tend to be higher at new stores compared to comparable stores, as new stores require a certain level of staffing in order to maintain adequate levels of customer service combined with lower sales. As new stores increase their sales, labor related expenses as a percentage of sales typically decrease.

Administrative expenses

Administrative expenses consist of home office related expenses, such as salary and benefits, share-based compensation, office supplies, hardware and software expenses, depreciation and amortization expense, occupancy costs (including rent, common area maintenance, real estate taxes and utilities), professional services expenses, expenses associated with our board and other general and administrative expenses. Depreciation expense included in administrative expenses relates to depreciation for assets directly used at the home office including depreciation on land improvements, leasehold improvements, fixtures and equipment and computer hardware and software.

Pre-opening and relocation expenses

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Pre-opening and relocation expenses may include rent expense, salaries, advertising, supplies and other miscellaneous costs incurred prior to the store opening. Rent expense is generally incurred from one to four months prior to a store's opening date for store leases classified as operating. For store leases classified as capital or financing leases, no pre-opening rent expense is recognized. Other pre-opening and relocation expenses are generally incurred in the 60 days prior to the store opening. Certain advertising and promotional costs associated with opening a new store may be incurred both before and after the store opens. All pre-opening and relocation costs are expensed as incurred.

Operating income

Operating income consists of gross profit less store expenses, administrative expenses and pre-opening and relocation expenses. Operating income can be impacted by a number of factors, including the timing of new store openings and store relocations, whether or not a store lease is classified as an operating or a capital or financing lease, as well as increases in store expenses and administrative expenses. The amount of time it takes for new stores to become profitable can vary depending on a number of factors, including location, competition, a new market versus an existing market, the strength of store management, general economic conditions and the amount of time it takes a new store to become mature.

Interest expense

Interest expense consists of the interest associated with capital and financing lease obligations. Interest expense also includes interest we pay on our outstanding indebtedness, which includes our revolving credit facility.

Table of Contents**Results of Operations**

The following table presents key components of our results of operations expressed as a percentage of net sales for the periods presented:

| | Three months ended | | Six months ended | |
|--|--------------------|----------------|------------------|----------------|
| | 2014 | March 31, 2013 | 2014 | March 31, 2013 |
| Statements of Income Data:* | | | | |
| Net sales | 100.0% | 100.0 | 100.0 | 100.0 |
| Cost of goods sold and occupancy costs | 70.3 | 70.1 | 70.5 | 70.5 |
| Gross profit | 29.7 | 29.9 | 29.5 | 29.5 |
| Store expenses | 20.6 | 20.8 | 20.7 | 20.9 |
| Administrative expenses | 2.7 | 3.1 | 3.0 | 3.3 |
| Pre-opening and relocation expenses | 0.9 | 0.7 | 0.8 | 0.7 |
| Operating income | 5.5 | 5.2 | 5.0 | 4.6 |
| Interest expense | (0.5) | (0.4) | (0.6) | (0.3) |
| Income before income taxes | 4.9 | 4.8 | 4.4 | 4.3 |
| Provision for income taxes | (1.9) | (1.8) | (1.7) | (1.6) |
| Net income | 3.1% | 3.0 | 2.8 | 2.7 |

*Figures may not sum due to rounding.

| | | | | |
|--|-------|------|------|------|
| Number of stores at end of period | 81 | 65 | 81 | 65 |
| Number of stores opened during the period | 5 | 4 | 9 | 6 |
| Total store unit count increase period over period | 24.6% | 22.6 | 24.6 | 22.6 |
| Change in comparable store sales | 6.9 | 8.1 | 8.7 | 10.4 |
| Change in daily average comparable store sales | 5.7 | 10.6 | 8.1 | 11.6 |
| Change in mature store sales | 4.9 | 3.5 | 5.9 | 5.7 |
| Change in daily average mature store sales | 3.7 | 5.8 | 5.3 | 6.9 |

Three months ended March 31, 2014 compared to the three months ended March 31, 2013

The following table summarizes our results of operations and other operating data for the periods presented, dollars in thousands:

| | Three months ended | | Increase (Decrease) | |
|--|--------------------|----------------|---------------------|---------|
| | 2014 | March 31, 2013 | Dollars | Percent |
| Statements of Income Data: | | | | |
| Net sales | \$ 130,343 | 106,485 | 23,858 | 22.4% |
| Cost of goods sold and occupancy costs | 91,590 | 74,668 | 16,922 | 22.7 |
| Gross profit | 38,753 | 31,817 | 6,936 | 21.8 |
| Store expenses | 26,877 | 22,163 | 4,714 | 21.3 |

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| | | | | |
|-------------------------------------|----------|---------|-------|--------|
| Administrative expenses | 3,548 | 3,342 | 206 | 6.2 |
| Pre-opening and relocation expenses | 1,211 | 796 | 415 | 52.1 |
| Operating income | 7,117 | 5,516 | 1,601 | 29.0 |
| Other (expense) income: | | | | |
| Interest expense | (704) | (401) | (303) | 75.6 |
| Other income, net | 1 | 2 | (1) | (50.0) |
| Income before income taxes | 6,414 | 5,117 | 1,297 | 25.3 |
| Provision for income taxes | (2,415) | (1,900) | (515) | 27.1 |
| Net income | \$ 3,999 | 3,217 | 782 | 24.3 |

Net sales

Net sales increased \$23.9 million, or 22.4%, to \$130.3 million for the three months ended March 31, 2014 compared to \$106.5 million for the three months ended March 31, 2013, primarily due to a \$16.6 million increase in sales from new stores and a \$7.3 million, or 6.9%, increase in comparable store sales. Daily average comparable store sales increased 5.7% for the three months

Table of Contents

ended March 31, 2014 as compared to the three months ended March 31, 2013. The daily average comparable store sales increase was primarily driven by a 2.0% increase in daily average transaction count and a 3.7% increase in average transaction size. Comparable store average transaction size was \$36.76 in the three months ended March 31, 2014 compared to \$36.37 in the three months ended March 31, 2013. Daily average mature store sales increased 3.7% in the three months ended March 31, 2014 as compared to three months ended March 31, 2013.

Gross profit

Gross profit increased \$6.9 million, or 21.8%, to \$38.8 million for the three months ended March 31, 2014 compared to \$31.8 million for the three months ended March 31, 2013, primarily driven by positive comparable store sales and new store growth. Gross margin decreased slightly to 29.7% for the three months ended March 31, 2014 from 29.9% for the three months ended March 31, 2013 primarily due to an increase in occupancy costs as a percentage of sales for the three months ended March 31, 2014 as compared to the three months ended March 31, 2013, partially offset by an increase in product gross margin. The positive impact in product margin is due to increased product margin across most departments, offset by a shift in sales mix towards products with lower margin in the three months ended March 31, 2014 as compared to the three months ended March 31, 2013. Gross margin benefited from operating efficiencies at the bulk food repackaging and distribution center in the three months ended March 31, 2014 as compared to the three months ended March 31, 2013. The increase in occupancy costs were primarily due to increased average lease expenses at new stores.

The Company had nine and seven leases for stores which were classified as capital and financing lease obligations for the three months ended March 31, 2014 and 2013, respectively. If these leases had qualified as operating leases, the straight-line rent expense would have been included in occupancy costs, and our costs of goods sold and occupancy costs as a percentage of sales during the three months ended March 31, 2014 and 2013 would have been approximately 60 and 40 basis points higher, respectively, than as reported.

Store expenses

Store expenses increased \$4.7 million, or 21.3%, to \$26.9 million in the three months ended March 31, 2014 from \$22.2 million in the three months ended March 31, 2013. Store expenses as a percentage of sales were 20.6% and 20.8% for the three months ended March 31, 2014 and 2013, respectively. The decrease in store expenses as a percentage of sales was primarily due to a decrease in salaries, benefits and related expenses at comparable stores, as well as a decrease in advertising expenses, partially offset by increases in depreciation and, to a lesser extent, utilities expense. The decrease in salaries, benefits and related expenses at comparable stores was due to leverage from the increase in sales, as the increased salary related expenses required to support the sales growth was less than the increase in sales. The decrease in advertising expenses was primarily due to lower television advertising during the quarter.

Administrative expenses

Administrative expenses increased \$0.2 million, or 6.2%, to \$3.5 million for the three months ended March 31, 2014 compared to \$3.3 million for the three months ended March 31, 2013, primarily due to the addition of general and administrative positions to support our store growth, as well as increased share-based compensation costs. Administrative expenses as a percentage of sales were 2.7% and 3.1% for the three months ended March 31, 2014 and 2013, respectively. The decrease in administrative expenses as a percentage of sales was a result of our ability to support additional store investments and sales without proportionate increases in overhead expenses.

Pre-opening and relocation expenses

Pre-opening and relocation expenses increased \$0.4 million, or 52.1%, in the three months ended March 31, 2014 to \$1.2 million compared to \$0.8 million for the three months ended March 31, 2013, due to the increased number of new store openings, the impact of the timing of the openings and possession of stores that are not yet opened, and the lease classification for those stores that were opened. We opened five new stores for the three months ended March 31, 2014, all of which are classified as operating leases. We opened four new stores for the three months ended March 31, 2013, three of which were classified as capital and financing lease obligations with no straight-line rent expense included in preopening and relocation expenses. Pre-opening and relocation expenses as a percentage of sales were 0.9% and 0.7% for the three months ended March 31, 2014 and 2013, respectively.

Interest expense

Interest expense increased \$0.3 million, or 75.6%, to \$0.7 million in the three months ended March 31, 2014 compared to \$0.4 million for the three months ended March 31, 2013 due to an increase in interest expense related to capital and financing lease obligations. If the capital and financing lease obligations had qualified as operating leases, interest expense as a percent of sales would have been approximately 55 and 40 basis points lower than as reported in the three months ended March 31, 2014 and 2013, respectively.

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Table of Contents

Income taxes

Our effective income tax rate for the three months ended March 31, 2014 and 2013 was 37.7% and 37.1%, respectively. The increase in our effective income tax rate was primarily due to an increase in federal income taxes. Our federal income taxes increased because of additional taxable net income and a consequential higher tax rate. Our additional taxable net income was due in part to the impact of prior deductions for bonus depreciation.

Net income

Net income increased 24.3% to \$4.0 million, or \$0.18 diluted earnings per share, in the three months ended March 31, 2014 from \$3.2 million, or \$0.14 diluted earnings per share, in the three months ended March 31, 2013.

Six months ended March 31, 2014 compared to the six months ended March 31, 2013

The following table summarizes our results of operations and other operating data for the periods presented, dollars in thousands:

| | Six months ended | | Increase (Decrease) | |
|--|------------------|-------------------|---------------------|---------|
| | 2014 | March 31, 2013 | Dollars | Percent |
| Statements of Income Data: | | | | |
| Net sales | \$ 250,923 | 202,316 | 48,607 | 24.0% |
| Cost of goods sold and occupancy costs | 176,789 | 142,662 | 34,127 | 23.9 |
| Gross profit | 74,134 | 59,654 | 14,480 | 24.3 |
| Store expenses | 52,050 | 42,366 | 9,684 | 22.9 |
| Administrative expenses | 7,437 | 6,668 | 769 | 11.5 |
| Pre-opening and relocation expenses | 2,100 | 1,315 | 785 | 59.7 |
| Operating income | 12,547 | 9,305 | 3,242 | 34.8 |
| Other (expense) income: | | | | |
| Interest expense | (1,411) | (656) | (755) | 115.1 |
| Other income, net | 2 | 4 | (2) | (50.0) |
| Income before income taxes | 11,138 | 8,653 | 2,485 | 28.7 |
| Provision for income taxes | (4,217) | (3,215) | (1,002) | 31.2 |
| Net income | \$ 6,921 | 5,438 | 1,483 | 27.3 |

Net sales

Net sales increased \$48.6 million, or 24.0%, to \$250.9 million for the six months ended March 31, 2014 compared to \$202.3 million for the six months ended March 31, 2013 primarily due to a \$31.1 million increase in sales from new stores and a \$17.5 million, or 8.7%, increase in

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comparable store sales. Daily average comparable store sales increased 8.1% for the six months ended March 31, 2014 as compared to the six months ended March 31, 2013. The daily average comparable store sales increase was primarily driven by a 3.5% increase in daily average transaction count and a 4.4% increase in average transaction size. Comparable store average transaction size was \$36.67 in the six months ended March 31, 2014 compared to \$36.03 in the six months ended March 31, 2013. Daily average mature store sales increased 5.3% in the six months ended March 31, 2014 as compared to six months ended March 31, 2013.

Gross profit

Gross profit increased \$14.5 million, or 24.3%, to \$74.1 million for the six months ended March 31, 2014 compared to \$59.7 million for the six months ended March 31, 2013, primarily driven by positive comparable store sales and new store growth. Gross margin was 29.5% for each of the six months ended March 31, 2014 and 2013. Gross margin for the six months ended March 31, 2014 was positively impacted by increases in product margin across almost all departments, partially offset by a shift in sales mix towards products with lower margin. Additionally, gross margin benefited from operating efficiencies at the bulk food repackaging and distribution center in the six months ended March 31, 2014 as compared to the six months ended March 31, 2013. Gross margin for the six months ended March 31, 2014 was negatively impacted by an increase in occupancy costs as a percentage of sales for the six months ended March 31, 2014 as compared to the six months ended March 31, 2013 primarily due to increased average lease expenses at new stores.

The Company had nine and seven leases for stores which were classified as capital and financing lease obligations for the six months ended March 31, 2014 and 2013, respectively. If these leases had qualified as operating leases, the straight-line expense

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Table of Contents

would have been included in occupancy costs, and our costs of goods sold and occupancy costs as a percentage of sales during the six months ended March 31, 2014 and 2013 would have been approximately 60 and 35 basis points higher, respectively, than as reported.

Store expenses

Store expenses increased \$9.7 million, or 22.9%, to \$52.1 million in the six months ended March 31, 2014 from \$42.4 million in the six months ended March 31, 2013. Store expenses as a percentage of sales were 20.7% and 20.9% for the six months ended March 31, 2014 and 2013, respectively. The decrease in store expenses as a percentage of sales was primarily due to a decrease in salaries, benefits and related expenses at comparable stores, partially offset by increases in depreciation expense at both comparable and new stores. The decrease in salaries, benefits and related expenses at comparable stores was due to leverage from the increase in sales, as the increased salary related expenses required to support the sales growth was less than the increase in sales.

Administrative expenses

Administrative expenses increased \$0.8 million, or 11.5%, to \$7.4 million for the six months ended March 31, 2014 compared to \$6.7 million for the six months ended March 31, 2013, primarily due to the addition of general and administrative positions to support our store growth, as well as increased share-based compensation costs. Administrative expenses as a percentage of sales were 3.0% and 3.3% for the six months ended March 31, 2014 and 2013, respectively. The decrease in administrative expenses as a percentage of sales was a result of our ability to support additional store investments and sales without proportionate increases in overhead expenses.

Pre-opening and relocation expenses

Pre-opening and relocation expenses increased \$0.8 million, or 59.7%, in the six months ended March 31, 2014 to \$2.1 million compared to \$1.3 million for the six months ended March 31, 2013, due to the increased number of new store openings, the impact of the timing of the openings and possession of stores that are not yet opened, and the lease classification for those stores that were opened. We opened nine new stores and remodeled one store for the six months ended March 31, 2014, one of which was classified as a capital and financing lease obligation with no straight-line rent expense included in preopening and relocation expenses. We opened six new stores for the six months ended March 31, 2013, five of which were classified as capital and financing lease obligations with no straight-line rent expense included in preopening and relocation expenses. Pre-opening and relocation expenses as a percentage of sales were 0.8% and 0.7% for the six months ended March 31, 2014 and 2013, respectively.

Interest expense

Interest expense increased \$0.8 million, or 115.1%, to \$1.4 million in the six months ended March 31, 2014 compared to \$0.7 million for the six months ended March 31, 2013 due to an increase in interest expense related to capital and financing lease obligations. If the capital and financing lease obligations had qualified as operating leases, interest expense as a percent of sales would have been approximately 55 and 30 basis points lower than as reported in the six months ended March 31, 2014 and 2013, respectively.

Income taxes

Our effective income tax rate for the six months ended March 31, 2014 and 2013 was 37.9% and 37.2%, respectively. The increase in our effective income tax rate was primarily due to an increase in federal income taxes. Our federal income taxes increased because of additional taxable net income and a consequential higher tax rate. Our additional taxable net income was due in part to the impact of prior deductions for bonus depreciation.

During the first quarter of fiscal year 2014, the Company experienced benefits from the American Taxpayer Relief Act of 2012, which extended the 50% bonus depreciation on qualifying assets and the special 15 year life for qualified leasehold property and qualified retail improvement property for property acquired from January 1, 2013 through December 31, 2013. The Company does not anticipate future benefits from the American Taxpayer Relief Act of 2012 because its provisions expired as of December 31, 2013 and no precedent exists for it being retroactively reauthorized by Congress.

The Company also benefited from the extension of the Work Opportunity Tax Credit during the quarter ended December 31, 2013. Although the legislative authority for this credit expired December 31, 2013, the Company believes it may benefit from the credit in the future if Congress reauthorizes it.

Net income

Net income increased 27.3% to \$6.9 million, or \$0.31 diluted earnings per share, in the six months ended March 31, 2014 from \$5.4 million, or \$0.24 diluted earnings per share, in the six months ended March 31, 2013.

Table of Contents

EBITDA

EBITDA increased 28.4% to \$11.2 million in the three months ended March 31, 2014 compared to \$8.8 million in the three months ended March 31, 2013. EBITDA increased 32.6% to \$20.6 million in the six months ended March 31, 2014 compared to \$15.5 million in the six months ended March 31, 2013. EBITDA as a percent of sales was 8.6% and 8.2% for the three months ended March 31, 2014 and 2013, respectively. EBITDA as a percent of sales was 8.2% and 7.7% for the six months ended March 31, 2014 and 2013, respectively. The stores with leases that are classified as capital and financing lease obligations, rather than being reflected as operating leases, increased EBITDA as a percentage of sales by approximately 60 and 55 basis points for the three months ended March 31, 2014 and 2013, respectively, and by approximately 60 and 45 basis points for the six months ended March 31, 2014 and 2013, respectively, due to the impact on cost of goods sold and occupancy costs as discussed above, as well as occupancy costs that would have been included in pre-opening expenses prior to the stores opening dates if these leases had been accounted for as operating leases.

EBITDA is not a measure of financial performance under GAAP. We define EBITDA as net income before interest, taxes, depreciation and amortization. We believe EBITDA provides additional information about (i) our operating performance, because it assists us in comparing the operating performance of our stores on a consistent basis, as it removes the impact of non-cash depreciation and amortization expense as well as items not directly resulting from our core operations such as interest expense and income taxes and (ii) our performance and the effectiveness of our operational strategies. Additionally, EBITDA performance is a measure in our incentive compensation payments.

Furthermore, management believes some investors use EBITDA as a supplemental measure to evaluate the overall operating performance of companies in our industry. Management believes that some investors' understanding of our performance is enhanced by including this non-GAAP financial measure as a reasonable basis for comparing our ongoing results of operations. By providing this non-GAAP financial measure, together with a reconciliation from net income, we believe we are enhancing investors' understanding of our business and our results of operations, as well as assisting investors in evaluating how well we are executing our strategic initiatives. Our competitors may define EBITDA differently, and as a result, our measure of EBITDA may not be directly comparable to EBITDA of other companies. Items excluded from EBITDA are significant components in understanding and assessing financial performance. EBITDA is a supplemental measure of operating performance that does not represent and should not be considered in isolation or as an alternative to, or substitute for, net income or other financial statement data presented in our consolidated financial statements as indicators of financial performance. EBITDA has limitations as an analytical tool, and should not be considered in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of the limitations are:

- EBITDA does not reflect our cash expenditures, or future requirements for capital expenditures or contractual commitments;
- EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- EBITDA does not reflect any impact for straight-line rent expense for leases classified as capital and financing lease obligations;
- EBITDA does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments on our debt;

- EBITDA does not reflect our tax expense or the cash requirements to pay our taxes; and
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future and EBITDA does not reflect any cash requirements for such replacements.

Due to these limitations, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business. We compensate for these limitations by relying primarily on our GAAP results and using EBITDA as supplemental information. We further believe that our presentation of this non-GAAP financial measurement provides information that is useful to analysts and investors because it is an important indicator of the strength of our operations and the performance of our business.

Table of Contents

The following table reconciles net income to EBITDA for the periods presented, dollars in thousands:

| | Three months ended March 31, | | Six months ended March 31, | |
|-------------------------------|---------------------------------|-------|-------------------------------|--------|
| | 2014 | 2013 | 2014 | 2013 |
| Net income | \$ 3,999 | 3,217 | 6,921 | 5,438 |
| Interest expense | 704 | 401 | 1,411 | 656 |
| Provision for income taxes | 2,415 | 1,900 | 4,217 | 3,215 |
| Depreciation and amortization | 4,116 | 3,233 | 8,054 | 6,225 |
| EBITDA | \$ 11,234 | 8,751 | 20,603 | 15,534 |

Liquidity and Capital Resources

Our primary sources of liquidity are cash generated from operations, current balances of cash and cash equivalents and availability under our revolving credit facility.

Our primary uses of cash are for capital expenditures predominantly in connection with opening new stores and relocating and remodeling certain existing stores, purchases of inventory, operating expense, debt service and corporate taxes. As of March 31, 2014, we had \$7.8 million in cash and cash equivalents and \$0.1 million in available-for-sale securities, as well as \$14.3 million available under our amended and restated revolving credit facility. As of March 31, 2014, we had an undrawn, issued and outstanding letter of credit of \$0.7 million which was reserved against the amount available for borrowing under the terms of our revolving credit facility. The Company had no amounts outstanding on the revolving credit facility as of March 31, 2014. On December 12, 2013, we entered into an amended and restated \$15.0 million credit agreement that, among other things, (i) extended the maturity date of the Company's revolving credit facility by three years to January 31, 2017, (ii) provides the Company with the right to request the issuance of letters of credit under the credit facility up to \$3.0 million, (iii) allows the Company to increase the amount available under the revolving credit facility, up to an additional amount that may not exceed \$10.0 million by obtaining an additional commitment or commitments, (iv) eliminated a requirement for a consolidated EBITDA to revenue ratio and (v) amended the unused commitment fee from 0.20% to amounts ranging from 0.15% to 0.35% based on certain conditions.

We plan to continue to open new stores, which has previously required and may in the future require us to borrow additional amounts under our revolving credit facility. We plan to spend approximately \$18 million to \$20 million on capital expenditures during the remaining six months of fiscal year 2014. We believe that cash and cash equivalents, together with the cash generated from operations and the borrowing availability under our revolving credit facility will be sufficient to meet our working capital needs and planned capital expenditures, including capital expenditures related to new store needs for at least the next twelve months. Our working capital 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.

We anticipate that our new stores will require, on average, an upfront capital investment of approximately \$2.5 million per store consisting of capital expenditures of approximately \$1.9 million, net of tenant allowances, initial inventory of approximately \$0.3 million, net of payables, and pre-opening expenses of approximately \$0.3 million.

Following is a summary of our operating, investing and financing activities for the periods presented, dollars in thousands:

| | Six months ended | | |
|---|------------------|----------|--|
| | March 31, | | |
| | 2014 | 2013 | |
| Net cash provided by operating activities | \$ 15,648 | 10,693 | |
| Net cash used in investing activities | (16,308) | (18,251) | |
| Net cash provided by (used in) financing activities | 342 | (236) | |
| Net decrease in cash and cash equivalents | (318) | (7,794) | |
| Cash and cash equivalents, beginning of period | 8,132 | 17,291 | |
| Cash and cash equivalents, end of period | \$ 7,814 | 9,497 | |

Operating Activities

Cash provided by operating activities consists primarily of net income adjusted for non-cash items, including depreciation and changes in deferred taxes, and the effect of working capital changes. Cash provided by operating activities increased \$5.0 million,

Table of Contents

or 46.3%, to \$15.6 million in the six months ended March 31, 2014, from \$10.7 million in the six months ended March 31, 2013. The increase in cash provided by operating activities was primarily due to an increase in net income, as adjusted for depreciation and amortization resulting from the addition of new stores, offset by changes in working capital driven by the timing of payment on inventory purchases. Our working capital requirements for inventory will likely continue to increase as we continue to open new stores.

Investing Activities

Cash used in investing activities decreased \$1.9 million, or 10.6%, to \$16.3 million in the six months ended March 31, 2014 from \$18.3 million in the six months ended March 31, 2013. Cash used in investing activities consists primarily of capital expenditures which increased \$0.2 million to \$17.9 million for the six months ended March 31, 2014 as compared to \$17.7 million for the six months ended March 31, 2013. We opened nine new stores during the six months ended March 31, 2014 compared to six new stores during the six months ended March 31, 2013. In the six months ended March 31, 2013, capital expenditures included approximately \$5.0 million of capital expenditures for assets acquired in the fourth quarter of fiscal year 2012, but paid during the first quarter of fiscal year 2013, including amounts related to our bulk food repackaging and distribution center. The remaining change in cash used for capital expenditures was due in part to the timing, costs and number of new stores opened during the six months ended March 31, 2014 as compared to the six months ended March 31, 2013. The cash used for capital expenditures was partially offset by a \$1.0 million reduction in our short term investments available-for-sale, as well as a \$0.5 million reduction in our restricted cash balance in the six months ended March 31, 2014.

Financing Activities

Cash provided by (used in) financing activities consists primarily of excess tax benefits on vested share-based compensation offset by payments of capital and financing lease obligations for the six months ended March 31, 2014. Cash provided by financing activities was \$0.3 million for the six months ended March 31, 2014, as compared to cash used in financing activities of \$0.2 million in the six months ended March 31, 2013. The increase in cash provided by financing activities for the six months ended March 31, 2014 was primarily due to an increase in excess tax benefits for vested share-based compensation, and a decrease in equity issuance costs paid.

Credit Facility

Credit Facility

We are a party to the \$15.0 million amended and restated revolving credit facility, which we may increase by an additional amount that may not exceed \$10.0 million, as further described above in *Liquidity and Capital Resources*. The operating company is the borrower under the credit facility, and its obligations under the credit facility are guaranteed by the holding company.

As of March 31, 2014, we had no amounts outstanding on the revolving credit facility, with a \$0.7 million letter of credit issued and outstanding and \$14.3 million available for borrowing. For floating rate borrowings under the credit facility, interest is determined by the lender's administrative agent less the lender spread, subject to the Company meeting certain financial measures. For fixed rate borrowings under the

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credit facility, interest is determined by quoted LIBOR rates for the interest period plus the lender spread, subject to us meeting certain financial measures.

The amended and restated revolving credit facility requires compliance with certain operational and financial covenants (including a leverage ratio and a fixed charge coverage ratio). The revolving credit facility also contains certain other limitations on our ability to incur additional debt, guarantee other obligations, grant liens on assets and make investments or acquisitions as defined in the agreement. Additionally, the revolving credit facility prohibits the payment of cash dividends to the holding company from the operating company, without the bank's consent except when no default or event of default exists. If no default or event of default exists, dividends are allowed for various audit, accounting, tax, securities, indemnification, reimbursement, insurance and other reasonable expenses in the ordinary course of business. We do not expect such restrictions to impact our ability to meet our cash obligations. The terms and conditions of the agreement for the revolving credit facility and associated documents are customary and include, among other things, guarantees, security interest grants, pledges and subordinations. As of March 31, 2014, we were in compliance with the debt covenants of our credit facility.

Table of Contents**Contractual Obligations**

The following table summarizes our contractual obligations as of March 31, 2014, dollars in thousands:

| | Total | Payments Due by Period | | | More than 5 years |
|--|------------|------------------------|-------------|-------------|----------------------|
| | | Less than 1 year | 1 - 3 years | 3 - 5 years | |
| Interest payments (1) | \$ 62 | 22 | 40 | | |
| Operating leases (2) | 248,838 | 19,423 | 40,395 | 38,919 | 150,101 |
| Capital and financing lease obligations, including principal and interest payments (3) | 42,351 | 2,978 | 5,955 | 5,983 | 27,435 |
| Contractual obligations for construction related activities (4) | 1,008 | 1,008 | | | |
| | \$ 292,259 | 23,431 | 46,390 | 44,902 | 177,536 |

(1) We assumed the interest payments to be paid during the remainder of the revolving credit facility using an unused commitment fee of 0.15% for amounts not borrowed as of March 31, 2014.

(2) Represents the minimum lease payments due under our operating leases, excluding annual common area maintenance, insurance and taxes related to our operating lease obligations.

(3) Represents the payments due under our capital and financing lease obligations for nine stores, all of which were open as of March 31, 2014. We do not record rent expense for these capital leases, but rather rental payments under the capital leases are recognized as a reduction of the capital and financing lease obligations and interest expense.

(4) Contractual obligations for construction related activities include future payments to general contractors that are legally binding as of March 31, 2014 and relate to new store construction, relocations and remodels.

Off-Balance Sheet Arrangements

As of March 31, 2014, our off-balance sheet arrangements consist of operating leases and the undrawn portion of our amended and restated revolving credit facility. All of our stores, bulk food repackaging facility and distribution center and administrative facilities are leased, and as of March 31, 2014, nine leases were classified as capital and financing lease obligations, and the remaining leases were classified as operating leases in our consolidated financial statements. We have no other off-balance sheet arrangements that have had, or are reasonably likely to have, a material current or future effect on our consolidated financial statements or financial condition.

Recent Accounting Pronouncements

See Note 2 to the consolidated financial statements included in this report on Form 10-Q.

Critical Accounting Policies

The preparation of our consolidated financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, expenses and related disclosures of contingent assets and liabilities. Actual amounts may differ from these estimates. We base our estimates on historical experience and on various other assumptions and factors that we believe to be reasonable under the circumstances. We evaluate our accounting policies and resulting estimates on an ongoing basis to make adjustments we consider appropriate under the facts and circumstances. Critical accounting policies that affect our more significant judgments and estimates used in the preparation of our financial statements include, accounting for income taxes, accounting for impairment of long-lived assets and accounting for leases, which are discussed in more detail under the caption "Critical Accounting Policies" in Management's Discussion and Analysis of Financial Condition and Results of Operations, set forth in Part II of our Form 10-K.

Table of Contents

Item 3. Qualitative and Quantitative Disclosures About Market Risk

We are exposed to interest rate changes of our long-term debt, and, to a limited extent, our revolving credit facility. We do not use financial instruments for trading or other speculative purposes. There have been no material changes regarding our market risk position from the information provided under Item 7A, Quantitative and Qualitative Disclosures about Market Risk in our Form 10-K.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our principal executive officers and principal financial and accounting officer, evaluated the effectiveness of our disclosure controls and procedures pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 as of the end of the period covered by this report on Form 10-Q. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Based on that evaluation, our principal executive officers and principal financial and accounting officer concluded that our disclosure controls and procedures were effective as of March 31, 2014.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

We periodically are involved in various legal proceedings that are incidental to the conduct of our business, including but not limited to employment discrimination claims, customer injury claims and investigations. When the potential liability from a matter can be estimated and the loss is considered probable, we record the estimated loss. Due to uncertainties related to the resolution of lawsuits, investigations and claims,

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the ultimate outcome may differ from our estimates. Although we cannot predict with certainty the ultimate resolution of any lawsuits, investigations and claims asserted against us, we do not believe any currently pending legal proceeding to which we are a party will have a material adverse effect on our business, prospects, financial condition, cash flows or results of operations.

Item 1A. Risk Factors

There have been no material changes from the risk factors disclosed in Part I, Item 1A, of our Form 10-K, other than the changes to the risk factors set forth below.

If we are unable to successfully identify market trends and react to changing consumer preferences in a timely manner, our sales may decrease.

We believe our success depends, in substantial part, on our ability to:

- anticipate, identify and react to natural and organic grocery and dietary supplement trends and changing consumer preferences in a timely manner;
- translate market trends into appropriate, saleable product and service offerings in our stores before our competitors; and
- develop and maintain vendor relationships that provide us access to the newest merchandise, and dairy products that satisfy upgraded standards, on reasonable terms.

Consumer preferences often change rapidly and without warning, moving from one trend to another among many product or retail concepts. Our performance is impacted by trends regarding natural and organic products, dietary supplements and at-home meal preparation. Consumer preferences towards dietary supplements or natural and organic food products might shift as a result of, among other things, economic conditions, food safety perceptions, reduced or changed consumer choices and the cost of these products. Our store offerings remain composed of natural and organic products and dietary supplements. A change in consumer preferences away

Table of Contents

from our offerings including as a result of, among other things, reductions or changes in our offerings, would have a material adverse effect on our business. Additionally, negative publicity over the safety of any such items, or upgraded standards that reduce or change consumer choices, may adversely affect demand for our products and could result in lower customer traffic, sales and results of operations. Reduced or changed consumer choices may result from, among other things our implementation of requirements for dairy products that satisfy our pasture-based, non-confinement standards.

If we are unable to anticipate and satisfy consumer merchandise preferences in the regions where we operate, our net sales may decrease, and we may be forced to increase markdowns of slow-moving merchandise, either of which could have a material adverse effect on our business, financial condition and results of operations.

Our future business, results of operations and financial condition may be adversely affected by reduced availability of organic products or dairy products that satisfy our pasture-based, non-confinement standards.

Our ability to ensure a continuing supply of organic products and dairy products that satisfy our pasture-based, non-confinement standards at competitive prices depends on many factors beyond our control, such as the number and size of farms that grow organic crops or raise organic livestock or satisfy our pasture-based, non-confinement standards, the vagaries of these farming businesses and our ability to accurately forecast our sourcing requirements. The organic ingredients used in many of the products we sell are vulnerable to adverse weather conditions and natural disasters, such as floods, droughts, frosts, earthquakes, hurricanes and pestilences. Adverse weather conditions and natural disasters can lower crop yields and reduce crop size and quality, which in turn could reduce the available supply of, or increase the price of, organic ingredients. Certain products we purchase from our suppliers include organic ingredients sourced offshore, and the availability of such ingredients may be affected by events in other countries. In addition, we and our suppliers compete with other food producers in the procurement of organic ingredients and dairy products that satisfy our pasture-based, non-confinement standards, which are often less plentiful in the open market than conventional ingredients and products. This competition may increase in the future if consumer demand increases for organic products and dairy products that satisfy our pasture-based, non-confinement standards. If supplies of organic ingredients and dairy products that satisfy our pasture-based, non-confinement standards are reduced or there is greater demand for such ingredients from us and others, we may not be able to obtain sufficient supply on favorable terms, or at all, which could impact our ability to supply products to our stores and may adversely affect our business, results of operations and financial condition.

The organic products we sell rely on independent certification and must comply with the requirements of independent organizations or certification authorities in order to be labeled as such. Certain products we sell in our stores can lose their organic certification if a contract manufacturing plant becomes contaminated with non-organic materials or if it is not properly cleaned after a production run, among other issues. The loss of any independent certifications could reduce the availability of organic products that we can sell in our stores and harm our business.

Item 6. Exhibits

See Exhibit Index.

Table of Contents

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 hereunto duly authorized on May 1, 2014.

Natural Grocers by Vitamin Cottage, Inc.

By:

/s/ KEMPER ISELY
Kemper Isely, Co-President
(Principal Executive Officer)

By:

/s/ SANDRA BUFFA
Sandra Buffa, Chief Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

EXHIBIT INDEX

| Exhibit Number | Description |
|-----------------------|--|
| 31.1 | Certification of Kemper Isely, a Principal Executive Officer Required Under Section 302(a) of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Zephyr Isely, a Principal Executive Officer Required Under Section 302(a) of the Sarbanes-Oxley Act of 2002 |
| 31.3 | Certification of Sandra Buffa, Principal Financial Officer Required Under Section 302(a) of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Principal Executive Officers and Principal Financial Officer Required Under 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 101 ^ | The following materials from Natural Grocers by Vitamin Cottage, Inc.'s Quarterly Report on Form 10-Q for the quarter ended March 31, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets (unaudited), (ii) Consolidated Statements of Income (unaudited), (iii) Consolidated Statements of Comprehensive Income (unaudited), (iv) Consolidated Statements of Cash Flows (unaudited) and (v) notes to Unaudited Interim Consolidated Financial Statements. |

The certifications attached as Exhibit 32.1 that accompany this report on Form 10-Q, are not deemed filed with the Securities and Exchange Commission and are not to be incorporated by reference into any filing of Natural Grocers by Vitamin Cottage, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date of this report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

^ Furnished, not filed. Users of this data submitted electronically herewith are advised pursuant to Rule 406T of Regulation S-T that the interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Section 11 or 12 of the Securities Act of 1933, are deemed not filed for purposes of Section 18 of the Securities Act of 1933, and otherwise are not subject to liability under these sections.