UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark one)

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

For the quarterly period ended October 7, 2018

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

For the transition period from to .

Commission File Number: 001-36626

Smart & Final Stores, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**80-0862253**
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)
600 Citadel Drive Commerce, California	**90040**
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: **(323) 869-7500**

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No o

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o	Smaller reporting company o
Emerging growth company o	

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common units, as of the latest practicable date.

Class	Outstanding at November 12, 2018
common stock, $0.001 par value	76,007,689

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Part I - FINANCIAL INFORMATION

Item 1. Financial Statements

Smart & Final Stores, Inc. and Subsidiaries
Condensed Consolidated Balance Sheets
(In Thousands, Except Share and Per Share Amounts)

	October 7, 2018 (Unaudited)	December 31, 2017
Assets		
Current assets:		
Cash and cash equivalents	$ 62,174	$ 71,671
Accounts receivable, less allowances of $177 and $177 at October 7, 2018 and December 31, 2017, respectively	37,937	33,019
Inventories	291,963	289,712
Prepaid expenses and other current assets	41,135	54,241
Total current assets	433,209	448,643
Property, plant, and equipment:		
Land	8,816	10,076
Buildings and improvements	47,943	53,965
Leasehold improvements	367,869	346,181
Fixtures and equipment	447,511	421,912
Construction in progress	44,023	8,242
	916,162	840,376
Less accumulated depreciation and amortization	407,276	338,149
	508,886	502,227
Assets under capital leases	13,535	—
Capitalized software, net of accumulated amortization of $19,570 and $17,325 at October 7, 2018 and December 31, 2017, respectively	29,957	21,984
Other intangible assets, net	357,306	362,536
Goodwill	385,918	385,918
Equity investment in joint venture	16,746	15,380
Other assets	83,002	73,249
Total assets	$ 1,828,559	$ 1,809,937
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	$ 235,551	$ 245,009
Accrued salaries and wages	34,227	36,216
Accrued expenses	111,026	100,639
Current portion of debt, less debt issuance costs	34,029	81,512
Total current liabilities	414,833	463,376
Obligations under capital leases	13,663	—
Long-term debt, less debt issuance costs	618,924	617,867
Deferred income taxes	39,487	38,095
Postretirement and postemployment benefits	118,796	127,649
Other long-term liabilities	199,387	159,904
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, $0.001 par value; Authorized shares — 10,000,000 Issued and outstanding shares — none	—	—
Common stock, $0.001 par value;		
Authorized shares — 340,000,000 Issued and outstanding shares - 75,987,863 and 74,120,113 at October 7, 2018 and December 31, 2017, respectively	76	74
Additional paid-in capital	517,395	506,098
Retained deficit	(68,493)	(78,160)
Accumulated other comprehensive loss	(25,509)	(24,966)
Total stockholders' equity	423,469	403,046
Total liabilities and stockholders' equity	$ 1,828,559	$ 1,809,937

See notes to condensed consolidated financial statements.

Smart & Final Stores, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations and Comprehensive Income
(Unaudited)
(In Thousands, Except Share and Per Share Amounts)

	Sixteen Weeks Ended		Forty Weeks Ended	
	October 7, 2018	October 8, 2017	October 7, 2018	October 8, 2017
Net sales	$ 1,497,669	$ 1,457,353	$ 3,639,390	$ 3,502,657
Cost of sales, buying and occupancy	1,265,220	1,243,490	3,090,962	2,993,413
Gross margin	232,449	213,863	548,428	509,244
Operating and administrative expenses	209,890	195,285	507,892	474,021
Income from operations	22,559	18,578	40,536	35,223
Interest expense, net	13,250	11,229	32,165	27,738
Equity in earnings of joint venture	651	362	1,601	576
Income before income taxes	9,960	7,711	9,972	8,061
Income tax benefit (provision)	200	(2,605)	(305)	(419)
Net income	$ 10,160	$ 5,106	$ 9,667	$ 7,642
Basic income per share	$ 0.14	$ 0.07	$ 0.13	$ 0.11
Diluted income per share	$ 0.14	$ 0.07	$ 0.13	$ 0.10
Weighted average shares outstanding:				
Basic	73,117,389	72,446,404	72,713,906	72,437,033
Diluted	74,446,660	74,253,374	74,071,704	75,588,182
Comprehensive income:				
Net income	$ 10,160	$ 5,106	$ 9,667	$ 7,642
Derivative instruments:				
(Loss) gain, net of income tax expense (benefit) of $0 and $127, respectively, for sixteen weeks ended; $(51) and $398, respectively, for forty weeks ended	—	190	(138)	596
Reclassification adjustments, net of income tax expense of $0 and $4, respectively, for sixteen weeks ended; $6 and $10, respectively, for forty weeks ended	—	6	15	14
Foreign currency translation	(514)	122	(420)	278
Other comprehensive (loss) income	(514)	318	(543)	888
Comprehensive income	$ 9,646	$ 5,424	$ 9,124	$ 8,530

See notes to condensed consolidated financial statements.

Smart & Final Stores, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited)
(In Thousands)

	Forty Weeks Ended	
	October 7, 2018	October 8, 2017
Operating activities		
Net income	$ 9,667	$ 7,642
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	44,953	44,526
Amortization	31,293	30,522
Amortization of debt discount and debt issuance costs	1,601	1,485
Share-based compensation	10,057	8,504
Deferred income taxes	1,439	(506)
Equity in earnings of joint venture	(1,601)	(576)
Loss (Gain) on disposal of property, plant, and equipment	559	(50)
Asset impairment	3,182	1,430
Changes in operating assets and liabilities:		
Accounts receivable, net	(4,918)	(3,858)
Inventories	(2,251)	7,391
Prepaid expenses and other assets	12,672	16,404
Accounts payable	(9,458)	(758)
Accrued salaries and wages	(1,989)	3,240
Other accrued liabilities	14,251	12,644
Net cash provided by operating activities	109,457	128,040
Investing activities		
Purchases of property, plant, and equipment	(95,891)	(107,078)
Proceeds from disposal of property, plant, and equipment	33	1,850
Investment in capitalized software	(11,846)	(10,505)
Other	(231)	(579)
Net cash used in investing activities	(107,935)	(116,312)
Financing activities		
Proceeds from exercise of stock options	1,885	3,780
Payment of minimum withholding taxes on net share settlement of share-based compensation awards	(645)	(1,826)
Fees paid in conjunction with debt financing	(180)	(154)
Borrowings on bank line of credit	47,000	63,000
Payments on bank line of credit	(93,000)	(57,000)
Payment on promissory note	(1,775)	—
Cash received from landlord related to financing lease obligations	35,696	—
Stock repurchases	—	(12,873)
Net cash used in financing activities	(11,019)	(5,073)
Net (decrease) increase in cash and cash equivalents	(9,497)	6,655
Cash and cash equivalents at beginning of period	71,671	54,235
Cash and cash equivalents at end of period	$ 62,174	$ 60,890
Cash paid during the period for:		
Interest	$ 29,171	$ 26,191
Non-cash investing and financing activities		
Software development costs incurred but not paid	$ 3,508	$ 331
Construction in progress costs incurred but not paid	18,511	26,093
Property acquired through capital and financing lease obligations	14,369	—

See notes to condensed consolidated financial statements.

Smart & Final Stores, Inc. and Subsidiaries
Condensed Consolidated Statements of Stockholders' Equity
(Unaudited)
(In Thousands, Except Share Amounts)

	Common Stock										
	Number of Shares		Amount		Additional Paid-In Capital		Retained Deficit		Accumulated Other Comprehensive Loss		Total
Balance at December 31, 2017	74,120,113	$	74	$	506,098	$	(78,160)	$	(24,966)	$	403,046
Issuance of restricted stock awards	1,370,576		1		—		—		—		1
Forfeiture of restricted stock awards	(25,334)		—		—		—		—		—
Share-based compensation	—		—		10,057		—		—		10,057
Stock option exercises	635,388		1		1,885		—		—		1,886
Vested restricted stock awards withheld on net share settlement	(112,880)		—		(645)		—		—		(645)
Net income	—		—		—		9,667		—		9,667
Other comprehensive loss	—		—		—		—		(543)		(543)
Balance at October 7, 2018	75,987,863	$	76	$	517,395	$	(68,493)	$	(25,509)	$	423,469

See notes to condensed consolidated financial statements.

Smart & Final Stores, Inc. and Subsidiaries
Notes to Unaudited Condensed Consolidated Financial Statements

1. Description of Business and Basis of Presentation

Business

Smart & Final Stores, Inc., a Delaware corporation ("SFSI" and, collectively with its wholly owned consolidated subsidiaries, the "Company"), is engaged primarily in the business of selling fresh perishables and everyday grocery items, together with foodservice, packaging and janitorial products. The Company operates non-membership, warehouse-style stores offering products in a range of product sizes.

SFSI was formed in connection with the acquisition of the "Smart & Final" and "Smart Foodservice" store businesses through the purchase of all of the outstanding common stock of Smart & Final Holdings Corp., a Delaware corporation (the "Predecessor"), on November 15, 2012. The principal acquiring entities were affiliates of Ares Management, L.P. ("Ares") and the acquisition is referred to as the "Ares Acquisition."

The Company operates non-membership warehouse-style grocery stores under the "Smart & Final" banner and the "Smart Foodservice" banner. As of October 7, 2018, the Company operated 324 stores throughout the Western United States ("U.S.").

The Company owns a 50% joint venture interest in a Mexican domestic corporation, Smart & Final del Noroeste, S.A. de C.V. ("SFDN"), which operated 15 "Smart & Final" format stores in northwestern Mexico as of October 7, 2018.

Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") for interim financial statements, and Rule 10-01 of Regulation S-X of the Securities Act of 1933, as amended (the "Securities Act"). The unaudited condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, considered necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the periods indicated. All intercompany accounts and transactions have been eliminated in consolidation. Interim results are not necessarily indicative of results for a full fiscal year. The information included in these unaudited condensed consolidated financial statements and notes thereto should be read in conjunction with the Company's audited consolidated financial statements as of and for the fiscal year ended December 31, 2017 that were included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission (the "SEC") on March 16, 2018.

Fiscal Years

The Company's fiscal year is the 52- or 53-week period that ends on the Sunday closest to December 31. Each fiscal year typically consists of twelve-week periods in the first, second and fourth quarters and a sixteen-week period in the third quarter. Fiscal year 2018 is, and fiscal year 2017 was, a 52-week fiscal year.

2. Significant Accounting Policies

Cash and Cash Equivalents

The Company considers all highly liquid instruments purchased with an original maturity of three months or less to be cash equivalents. All credit card, debit card and electronic benefits transfer transactions that process in less than seven days are classified as cash equivalents. The carrying amount of cash equivalents is approximately the same as their respective fair values due to the short-term maturity of these instruments.

Accounts Receivable, Net

Accounts receivable generally represent billings to customers, billings to vendors for earned rebates and allowances, receivables from SFDN, and other items. The receivable from SFDN primarily relates to billings for the shipment of inventory product to SFDN.

The Company evaluates the collectability of accounts receivable and determines the appropriate reserve for doubtful accounts based on analysis of historical trends of write-offs and recoveries on various levels of aged receivables. When the Company becomes aware of the deteriorated collectability of a specific account, additional reserves are made to reduce the net recognized receivable to the amount reasonably expected to be collectible or zero. When the specific account is determined to be uncollectible, the net recognized receivable is written off in its entirety against such reserves.

The Company is exposed to credit risk on trade accounts receivable. The Company provides credit to certain trade customers in the ordinary course of business and performs ongoing credit evaluations. Concentrations of credit risk with respect to trade accounts receivable are limited due to the number of customers comprising the Company's customer base. The Company currently believes the allowance for doubtful accounts is sufficient to cover customer credit risks.

Inventories

Inventories consist of merchandise purchased for resale which is stated at the lower of weighted-average cost (which approximates first-in, first-out ("FIFO")) or net realizable value. The Company provides for estimated inventory losses between physical inventory counts at its stores based upon historical inventory losses as a percentage of sales. The provision is adjusted periodically to reflect updated trends of actual physical inventory count results.

Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets include primarily prepaid rent, insurance, property taxes, income taxes receivable, properties held for sale and other current assets.

As of October 7, 2018, the Company designated properties as held for sale in the amount of $11.0 million.

Property, Plant, and Equipment

Property, plant, and equipment is stated at cost less accumulated depreciation and depreciated or amortized using the straight-line method. Leased property meeting certain criteria is capitalized and the amortization is based on the straight-line method over the term of the lease.

The estimated useful lives are as follows:

Buildings and improvements	20 - 25 years
Fixtures and equipment	3 - 10 years
Leasehold improvements	Lesser of lease term or useful life of improvement

Costs of normal maintenance and repairs and minor replacements are charged to expense when incurred. Major replacements, remodeling or betterments of properties are capitalized. When assets are sold or otherwise disposed of, the costs and related accumulated depreciation and amortization are removed from the accounts, and any resulting gain or loss is included in the condensed consolidated statements of operations and comprehensive income.

Included in property, plant, and equipment are costs associated with the selection and procurement of real estate sites. These costs are amortized over the remaining lease term of the successful sites with which they are associated.

The Company reviews its long-lived assets, including property, plant and equipment for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company groups and evaluates long-lived assets for impairment at the individual store level, which is the lowest level at which individual cash flows can be identified. The Company regularly reviews its stores' operating performance for indicators of impairment. Factors it considers important that could trigger an impairment review include a significant underperformance relative to expected historical or projected future operating results, a significant change in the manner of the use of the asset or a significant negative industry or economic trend. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized to the extent the sum of the estimated discounted future cash flows from the use of the asset is less than the carrying value. The Company measured the fair value of its long-lived assets on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy. See Note 5, Fair Value Measurements.

Capitalized Software

Capitalized software costs are comprised of third-party purchased software costs, capitalized costs associated with internally developed software including internal direct labor costs, and installation costs. Such capitalized costs are amortized over the period that the benefits of the software are fully realizable and enhance the operations of the business, ranging from three to seven years, using the straight-line method.

Capitalized software costs, like other long-lived assets, are subject to review for impairment whenever events or changes in circumstances indicate that the carrying amount of the capitalized software may not be recoverable, whether it is in use or under development. Impairment is recognized to the extent the sum of the estimated discounted future cash flows from the use of the capitalized software is less than the carrying value.

Goodwill and Intangible Assets

Goodwill and intangible assets with indefinite lives are evaluated on an annual basis for impairment during the fourth quarter, or more frequently if events or changes in circumstances indicate that the asset might be impaired. The Company evaluates goodwill for impairment by comparing the fair value of each reporting unit to its carrying value including the associated goodwill. The Company has designated its reporting units to be its *Smart & Final* stores and *Smart Foodservice* stores. The Company determines the fair value of the reporting units using the income approach methodology of valuation that includes the discounted cash flow method as well as other generally accepted valuation methodologies. If the fair value of the reporting unit exceeds the carrying value of the net assets, including goodwill assigned to that unit, goodwill is not impaired. If the carrying value of the reporting unit's net assets, including goodwill, exceeds the fair value of the reporting unit, an impairment charge is recognized for the amount by which that carrying amount exceeds the fair value of the reporting unit.

The Company evaluates its indefinite-lived intangible assets associated with trade names by comparing the fair value of each trade name with its carrying value. The Company determines the fair value of the indefinite-lived trade names using a "relief from royalty payments" methodology. This methodology involves estimating reasonable royalty rates for each trade name and applying these royalty rates to a revenue stream and discounting the resulting cash flows to determine fair value.

During 2017, the Company experienced a sustained decline in its share price and market capitalization. Additionally, the market multiples of publicly traded peer companies also experienced a sustained decline over this time period reflecting an increasingly competitive environment. As a result of the changed market conditions the Company updated its short-term operating plan in the fourth quarter 2017 to reflect this environment. The annual evaluation of impairment for fiscal year 2017 was performed as of December 3, 2017 resulting in a goodwill impairment charge of $180.0 million associated with the S*mart & Final* reporting unit recorded in the fourth quarter of 2017.

The finite-lived intangible assets are amortized over their estimated useful benefit period and have the following weighted-average amortization periods:

Signature brands	20 years
Leasehold interests	24 years

Finite-lived intangible assets, like other long-lived assets are subject to review for impairment whenever events or changes in circumstances indicate that the carrying amount of the finite-lived intangible asset may not be recoverable. Impairment is recognized to the extent the sum of the discounted estimated future cash flows from the use of the finite-lived intangible asset is less than the carrying value.

Other Assets

Other assets primarily consist of assets held in trusts for certain retirement plans (see Note 6, Retirement Benefit Plans and Postretirement and Postemployment Benefit Obligations), insurance recovery receivables related to self-insurance, capitalized cloud computing implementation costs, liquor licenses and other miscellaneous assets.

Accounts Payable

The Company's banking arrangements provide for the daily replenishment and limited monthly advanced payments of vendor payable accounts as checks are presented or payments are demanded. The checks and the advanced payments outstanding in these bank accounts are included in "Accounts payable" in the accompanying condensed consolidated balance sheets.

Other Long-Term Liabilities

Other long-term liabilities include primarily general liability reserves, workers' compensation reserves, liabilities for the deferred compensation plan, leasehold interests, financing obligations for "build-to-suit" lease arrangements, and other miscellaneous long-term liabilities. These leasehold interests are amortized over their estimated useful benefit periods, which is typically the lease term. The weighted-average amortization period is 14 years.

Lease Accounting

Certain of the Company's operating leases provide for minimum annual payments that increase over the life of the lease. The aggregate minimum annual payments are charged to expense on a straight-line basis beginning when the Company takes possession of the property and extending over the term of the related lease. The amount by which straight-line rent expense exceeds actual lease payment requirements in the early years of the leases is accrued as deferred minimum rent and reduced in later years when the actual cash payment requirements exceed the straight-line expense. Accounting guidance for asset retirement obligations requires an entity to recognize a liability for the fair value of a conditional asset retirement obligation if the fair value of the liability can be reasonably estimated. Due to the nature of the Company's business, its asset retirement obligation with respect to owned or leased properties is not significant.

The Company records an asset and related financing lease obligation for the estimated construction costs under "build-to-suit" lease arrangements where it is considered, in substance, to be the owner of the building due to the Company's involvement in the building's construction. Upon occupancy and shortly thereafter, the Company assesses whether these arrangements qualify for sales recognition under the sale-leaseback accounting guidance. If the Company continues to be deemed the owner of the building, the Company will continue to account for the arrangement as a financing lease.

Store Opening and Closing Costs

New store opening costs consisting primarily of rent, store payroll and general operating costs are charged to expense as incurred prior to the store opening.

In the event a leased store is closed before the expiration of the associated lease, the discounted remaining lease obligation less estimated sublease rental income, asset impairment charges related to improvements and fixtures, inventory write-downs and other miscellaneous closing costs associated with the disposal activity are recognized when the store closes.

Share-Based Compensation

All share-based payments are recognized over the requisite service period in the condensed consolidated statements of operations and comprehensive income as compensation expense based on the fair value of an award, taking into consideration estimated forfeiture rates.

The Company measures share-based compensation cost at the grant date based on the fair value of the award and recognizes share-based compensation cost as an expense over the award's vesting period. As share-based compensation expense recognized in the condensed consolidated statements of operations and comprehensive income of the Company is based on awards ultimately expected to vest, the amount of expense has been reduced for estimated forfeitures. The Company's forfeiture rate assumption used in determining its share-based compensation expense is estimated primarily based upon historical data. The actual forfeiture rate could differ from these estimates.

The Company uses the Black-Scholes-Merton option-pricing model to determine the grant date fair value for each stock option grant. The Black-Scholes-Merton option-pricing model requires extensive use of subjective assumptions. Application of alternative assumptions could produce significantly different estimates of the fair value of share-based compensation and, consequently, the related amounts recognized in the Company's condensed consolidated statements of operations and comprehensive income. The Company recognizes compensation cost for graded vesting awards as if they were granted in multiple awards. Management believes the use of this "multiple award" method is preferable because a stock option grant or restricted stock grant with graded vesting is effectively a series of individual grants that vest over various periods and management believes that this method provides for better matching of compensation costs with the associated services rendered throughout the applicable vesting periods. See Note 8, Share-Based Compensation.

Significant Accounting Estimates

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

Revenue Recognition

Revenues from the sale of products are recognized at the point of sale. Discounts provided to customers at the time of sale are recognized as a reduction in sales as the products are sold. Returns are also recognized as a reduction in sales and are immaterial in relation to total sales. The Company collects sales tax on taxable products purchased by its customers and remits such collections to the appropriate taxing authority in accordance with local laws. Sales tax collections are presented in the condensed consolidated statements of operations and comprehensive income on a net basis and, accordingly, are excluded from reported revenues.

In May 2014, the Financial Accounting Standards Board ("FASB") issued ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09"), which amended the existing accounting standards for revenue recognition. ASU 2014-09 establishes principles for recognizing revenue upon the transfer of promised goods or services to customers, in an amount that reflects the expected consideration received in exchange for those goods or services. The Company adopted ASU 2014-09 in the first quarter of 2018 using the modified retrospective approach. Because the Company's primary source of revenues is from the sale of products which are recognized at the point of sale, the impact on its consolidated financial statements is not material.

In March 2016, the FASB issued ASU No. 2016-08, *Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)* ("ASU 2016-08"), which amended existing accounting standards for revenue recognition. The Company adopted ASU 2016-08 in the first quarter of 2018 using the modified retrospective approach. The Company performed a detailed review of key contracts and comparison of historical accounting policies and practices to the new standard including principal versus agent considerations as amended through ASU 2016-08. The Company's analysis of its contracts under the new standard supports the recognition of revenue at the point of sale, consistent with its current revenue policy. Furthermore, the Company evaluated the principal versus agent considerations as it relates to certain arrangements with third parties and determined that there would be no impact to the presentation of gross or net revenue reporting.

Proceeds from the sale of the Company's Smart & Final gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer. The Smart & Final gift cards do not have an expiration date and the Company is not required to escheat the value of unredeemed gift cards in the applicable jurisdictions. The Company has determined a gift card breakage rate based upon historical redemption patterns. Estimated breakage amounts are accounted for under the redemption recognition method, which results in recognition of estimated breakage income in proportion to actual gift card redemptions.

Cost of Sales, Buying and Occupancy

The major categories of costs included in cost of sales, buying and occupancy are cost of goods, distribution costs, costs of the Company's buying department and store occupancy costs, net of earned vendor rebates and other allowances. Distribution costs consist of all warehouse receiving and inspection costs, warehousing costs, all transportation costs associated with shipping goods from the Company's warehouses to its stores, and other costs of its distribution network. The Company does not exclude any material portion of these costs from cost of sales.

Vendor Rebates and Other Allowances

As a component of the Company's consolidated procurement program, the Company frequently enters into contracts with vendors that provide for payments of rebates or other allowances. These vendor payments are reflected in the carrying value of the inventory when earned or as progress is made toward earning the rebate or allowance and as a component of cost of sales as the inventory is sold. Certain of these vendor contracts provide for rebates and other allowances that are contingent upon the Company meeting specified performance measures such as a cumulative level of purchases over a specified period of time. Such contingent rebates and other allowances are given accounting recognition at the point at which achievement of the specified performance measures are deemed to be probable and reasonably estimable.

Operating and Administrative Expenses

The major categories of operating and administrative expenses include store direct expenses associated with displaying and selling at the store level, primarily labor and related fringe benefit costs, advertising and marketing costs, overhead costs and corporate office costs. The Company charges to expense the costs of advertising as incurred.

Income Taxes

The Company recognizes deferred tax assets and liabilities based on the liability method, which requires an adjustment to the deferred tax asset or liability to reflect income tax rates currently in effect. When income tax rates increase or decrease, a corresponding adjustment to income tax expense is recorded by applying the rate change to the cumulative temporary differences. The Company also determines whether it is "more likely than not" that a tax position will be sustained upon examination by the appropriate taxing authorities before any part of the benefit can be recognized.

Foreign Currency Translations

The Company's joint venture in Mexico uses the Mexican Peso as its functional currency. The joint venture's assets and liabilities are translated into U.S. dollars at the exchange rates prevailing at the balance sheet dates. Revenue and expense accounts are translated into U.S. dollars at average exchange rates during the year. Foreign exchange translation adjustments are included in "Accumulated other comprehensive loss" ("AOCL"), which is reflected as a separate component of stockholders' equity, in the accompanying condensed consolidated balance sheets.

Derivative Financial Instruments

The Company uses interest rate swaps to manage a portion of its exposure to adverse fluctuations in interest rates. The contracts are accounted for in accordance with accounting guidance for derivatives and hedging, which requires every derivative instrument to be recorded in the Company's consolidated balance sheets as either an asset or liability measured at its fair value. The Company designates its interest rate swaps as cash flow hedges and formally documents its hedge relationships, including identification of the hedging instruments and the hedged items, as well as its risk management objectives and strategies for undertaking the hedge transaction. Accordingly, changes in estimated fair value related to the interest rate swaps are recognized in AOCL in the condensed consolidated statements of stockholders' equity and recognized in Foreign Currency Translation ("FCT") in the condensed consolidated statements of operations and comprehensive income when the hedged items affect earnings. The Company's interest rate swap agreement expired on March 29, 2018.

Debt Discount and Debt Issuance Costs

Costs incurred in connection with the placement of long-term debt paid directly to the Company's lenders are treated as a debt discount. Costs incurred in connection with the placement of long-term debt paid to third parties are treated as debt issuance costs and are amortized to interest expense over the term of the related debt using the effective interest method.

The Company presents capitalized debt issuance costs in its condensed consolidated balance sheets as a direct reduction to debt.

Self-Insurance

The Company has various insurance programs related to its risks and costs associated with workers' compensation and general liability claims. The Company has elected to purchase third-party insurance to cover the risk in excess of certain dollar limits established for each respective program. The Company establishes estimated accruals for its insurance programs based on available claims data, historical trends and experience, and projected ultimate costs of the claims. These accruals are based on estimates prepared with the assistance of outside actuaries and consultants, and the ultimate cost of these claims may vary from initial estimates and established accruals. The actuaries periodically update their estimates and the Company records such adjustments in the period in which such determination is made. Included in the aggregate accrual are amounts related to the risk in excess of certain dollar limits related to the Company's workers' compensation California self-insured program and its general liability program. The Company has also recorded a corresponding insurance recovery receivable from its third-party insurance carriers related to the risk in excess of certain reinsurance dollar limits related to such programs. The accrued obligation for these self-insurance programs and the corresponding insurance recovery receivable are included in "Other long-term liabilities" and "Other Assets," respectively, in the condensed consolidated balance sheets.

Fair Value of Financial Instruments

The Company's financial instruments recorded in the condensed consolidated balance sheets include cash and cash equivalents, accounts receivable, derivatives, investments in affiliates, accounts payable, accrued expenses and long-term variable rate debt. The carrying amounts of cash and cash equivalents, accounts receivable, derivatives, equity investment in joint venture, accounts payable and accrued expenses approximate fair value.

The Company's debt is not listed or traded on an established market. For the purpose of determining the fair value of the Company's first lien term loan facility (as amended, the "Term Loan Facility"), the administrative agent has provided to the Company the fair value of the Term Loan Facility based upon orderly trading activity and related closing prices for actual trades of the Term Loan Facility as well as indications of interest by prospective buyers and sellers and related bid/ask prices. As of October 7, 2018, the carrying value of the Term Loan Facility approximates fair value based upon valuations received from the administrative agent, which reflected a pricing valuation of 97.5% of carrying value. The carrying value of the Term Loan Facility was $625.0 million, compared to an indicated fair value of $609.4 million as of October 7, 2018. The Company's estimates of the fair value of long-term debt were classified as Level 2 in the fair value hierarchy.

The Company's condensed consolidated financial statements reflect its investment in Sprouts Farmers Market, Inc. ("Sprouts") through the Company's supplemental deferred compensation plan. The investment is presented at fair market value.

Accounting for Retirement Benefit Plans

The Company recognizes the overfunded or underfunded status of a defined benefit plan, measured as the difference between the fair value of plan assets and the plan's benefit obligation, as an asset or liability in its condensed consolidated balance sheets and recognizes changes to that funded status in the year in which the changes occur through accumulated other comprehensive loss. Measurement of the funded status of a plan is required as of the Company's consolidated balance sheet dates.

Earnings per Share

Basic earnings per share is calculated by dividing net income by the weighted average number of shares outstanding during the fiscal period.

Diluted earnings per share is calculated by dividing net income by the weighted average number of shares outstanding for the applicable period, inclusive of the effect of dilutive securities such as outstanding stock options and unvested restricted stock.

3. Recent Accounting Pronouncements

Recently Issued Accounting Pronouncements Not Yet Adopted

In February 2016, the FASB issued ASU No. 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). ASU 2016-02 will require organizations that lease assets, referred to as "lessees", to recognize on the balance sheet the assets and liabilities for the rights and obligations created by those leases. A lessee will be required to recognize assets and liabilities for leases with lease terms of more than 12 months. Consistent with current GAAP, the recognition, measurement and presentation of expenses and cash flows arising from a lease by a lessee primarily will depend on its classification as a financing or operating lease. However, unlike current GAAP, which requires only capital leases to be recognized on the balance sheet, ASU 2016-02 will require both types of leases to be recognized on the balance sheet. As a result, lessees will be required to put most leases on their balance sheets while recognizing expense on their income statements in a manner similar to current accounting. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company anticipates that the adoption of ASU 2016-02 will materially affect its consolidated balance sheets, with no material impact to its consolidated statements of operations. The Company is implementing changes to its systems and processes in conjunction with its review of existing lease agreements. The Company plans to use the optional transition method allowed by ASU 2016-02, which allows the Company to apply Accounting Standards Codification ("ASC") 840, *Leases*, in the comparative periods presented in the year of adoption. The cumulative effect of adoption would be recorded in the opening balance sheet in the period of adoption. The Company also plans to elect to use the package of practical expedients which permits the Company to not reassess whether: a contract is or contains a lease, lease classification, and initial direct costs. The adoption of ASU 2016-02 is expected to result in a material increase to the Company's condensed consolidated balance sheets for right-of-use assets and lease liabilities and enhanced disclosures.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* ("ASU 2016-13"). ASU 2016-13 replaces the incurred loss impairment methodology under current GAAP. The new guidance requires immediate recognition of estimated credit losses expected to occur for most financial assets and certain other instruments. For available-for-sale debt securities with unrealized losses, the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. It is effective for annual reporting periods beginning after December 15, 2019 and interim periods within those annual periods. Early adoption for annual reporting periods beginning after December 15, 2018 is permitted. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first effective reporting period. The Company is currently evaluating this guidance and the impact it will have on its consolidated financial statements.

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities* ("ASU 2017-12"). The new guidance amends the hedge accounting model to enable entities to better portray the economics of their risk management activities in the financial statements and enhance the transparency and understandability of hedge results. The amendments expand an entity's ability to hedge nonfinancial and financial risk components and reduce complexity in fair value hedges of interest rate risk. The guidance eliminates the requirement to separately measure and report hedge ineffectiveness and generally requires the entire change in the fair value of a hedging instrument to be presented in the same income statement line as the hedged item. The guidance also eases certain documentation and assessment requirements and modifies the accounting for components excluded from the assessment of hedge effectiveness. ASU 2017-12 is effective for annual and interim periods beginning after December 15, 2018 with early adoption permitted. The amended presentation and disclosure guidance is to be applied on a prospective basis. The Company does not expect the adoption of ASU 2017-12 will have a material impact on its consolidated financial statements.

In February 2018, the FASB issued ASU 2018-02, *Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income* ("ASU 2018-02"), which permits entities to reclassify tax effects stranded in accumulated other comprehensive income (loss) as a result of tax reform to retained earnings. Companies that elect to reclassify these amounts must reclassify stranded tax effects for all items accounted for in accumulated other comprehensive income (loss). ASU 2018-02 is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years with early adoption permitted. The Company does not expect the adoption of ASU 2018-02 will have a material impact on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, *Improvements to Nonemployee Share-Based Payment Accounting* ("ASU 2018-07"). The amendments expand the scope of ASC 718, *Compensation—Stock Compensation* ("ASC 718") to include share-based payment transactions for acquiring goods and services from nonemployees. An entity should apply the requirements of ASC 718 to nonemployee awards except for certain exemptions specified in the amendment. The guidance is effective for fiscal years beginning after December 15, 2018, including interim reporting periods within that fiscal year. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 will have a material impact on its consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-14, *Compensation —Retirement Benefits —Defined Benefit Plans — General (Subtopic 715-20) —Disclosure Framework —Changes to the Disclosure Requirements for Defined Benefit Plans* ("ASU 2018-14"). The amendments in this update change the disclosure requirements for employers that sponsor defined benefit pension and/or other post retirement benefit plans. It eliminates requirements for certain disclosures that are no longer considered cost beneficial and requires new disclosures that the FASB considers pertinent. The guidance is effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-14 will have a material impact on its consolidated financial statements or disclosures.

In August 2018, the FASB issued ASU No. 2018-15, *Intangibles —Goodwill and Other —Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* ("ASU 2018-15"). The amendments in this update align the requirements for capitalizing implementation costs incurred in a cloud computing arrangement (i.e. hosting arrangement) that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software under Subtopic 350-40. The amendments require certain costs incurred during the application development stage to be capitalized and other costs incurred during the preliminary project and post-implementation stages to be expensed as they are incurred. Capitalized implementation costs related to a hosting arrangement that is a service contract will be amortized over the term of the hosting arrangement including reasonably certain renewals, beginning when the module or component of the hosting arrangement is ready for its intended use. Accounting for the hosting component of the arrangement is not affected. The guidance is effective for fiscal years beginning after December 15, 2019, including interim periods within that fiscal year. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-15 will have a material impact on its consolidated financial statements.

4. Debt

Current portion of debt at October 7, 2018 and December 31, 2017 was as follows (in thousands):

	October 7, 2018	December 31, 2017
Revolving Credit Facility	$ 35,000	$ 81,000
Promissory Note	—	1,775
Less:		
Debt issuance costs	(971)	(1,263)
Total current portion of debt	$ 34,029	$ 81,512

Long-term debt at October 7, 2018 and December 31, 2017 was as follows (in thousands):

	October 7, 2018	December 31, 2017
Term Loan Facility	$ 625,000	$ 625,000
Less:		
Debt issuance costs	(1,939)	(2,298)
Discount on debt issuance	(4,137)	(4,835)
Total long-term debt	$ 618,924	$ 617,867

In conjunction with the Ares Acquisition, Smart & Final Stores LLC (“Smart & Final Stores”) entered into financing arrangements effective November 15, 2012, including the Term Loan Facility and an asset-based lending facility (the “Revolving Credit Facility”).

All obligations under the Term Loan Facility are secured by (1) a first-priority security interest in substantially all of the property and assets of, as well as the equity interests owned by, Smart & Final Stores and SF CC Intermediate Holdings, Inc., a direct wholly owned subsidiary of SFSI (“Intermediate Holdings”), and the other guarantors, with certain exceptions, and (2) a second-priority security interest in the Revolving Credit Facility collateral.

During the third quarter of 2016, the Company amended the Term Loan Facility (the “Fourth Amendment”) to increase the size of the Term Loan Facility by $30.1 million, from $594.9 million to $625.0 million, and to extend the original November 15, 2019 maturity date to November 15, 2022. Additionally, in connection with the Fourth Amendment, the Eurocurrency Borrowings applicable margin increased from 3.25% to 3.50%. As of October 7, 2018 and December 31, 2017, the weighted-average interest rate on the amount outstanding under the Term Loan Facility was 5.66% and 5.20%, respectively.

The Revolving Credit Facility originally provided financing of up to $150.0 million (including up to $50.0 million for the issuance of letters of credit) subject to a borrowing base, for a term of five years. The borrowing base is a formula based on certain eligible inventory and receivables, minus certain reserves.

All obligations under the Revolving Credit Facility are secured by (1) a first-priority security interest in the accounts receivable, inventory, cash and cash equivalents, and related assets of Smart & Final Stores and Intermediate Holdings and the other guarantors under the facility, and (2) a second-priority security interest in substantially all of the other property and assets of, as well as the equity interests owned by, Smart & Final Stores and Intermediate Holdings and the other guarantors under the facility.

During the third quarter of 2016, the Company amended the Revolving Credit Facility (the “Second Amendment”) to increase the committed amount to $200.0 million. Additionally, the maturity date was extended from November 15, 2017 to the earlier of (a) July 19, 2021 and (b) to the extent the Term Loan Facility (and any refinancing of the Term Loan Facility) has not been paid in full, the date that is 60 days prior to the earliest scheduled maturity date of the Term Loan Facility (or such refinancing of the Term Loan Facility). In addition, the applicable margin ranges were reduced with respect to (i) alternate base rate loans to 0.25% to 0.50% from 0.25% to 0.75% and (ii) LIBOR rate loans to 1.25% to 1.50% from 1.25% to 1.75%.

At October 7, 2018 and December 31, 2017, the alternate base rate was 5.00% and 4.50%, respectively and the applicable margin for alternate base rate loans was 0.25%, for a total rate of 5.25% and 4.75%, respectively. The calculated borrowing base of the Revolving Credit Facility was $201.7 million and $206.9 million at October 7, 2018 and December 31, 2017, respectively.

The Revolving Credit Facility also provides for a $65.0 million sub-limit for letters of credit, of which the Company had $47.1 million and $36.2 million outstanding as of October 7, 2018 and December 31, 2017, respectively. As of October 7, 2018 and December 31, 2017, the amount available for borrowing under the Revolving Credit Facility was $117.9 million and $82.8 million, respectively. The Revolving Credit Facility does not include financial covenant requirements unless a defined covenant trigger event has occurred and is continuing. As of October 7, 2018 and December 31, 2017, no trigger event had occurred.

During the third quarter of 2017, the Company entered into a Promissory Note to purchase certain real property for $1.8 million that is financed by the seller. During the third quarter of 2018, the Company repaid the Promissory Note in full.

5. Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. To estimate the fair values of its financial and nonfinancial assets and liabilities, the Company uses valuation approaches within a hierarchy that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company’s assumptions about the inputs that market participants would use in pricing the asset or liability and are developed based on the best information available in the circumstances. The fair value hierarchy is divided into three levels based on the source of inputs as follows:

Level 1—Quoted prices for identical instruments in active markets

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

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

The Company's assets and liabilities measured at fair value on a recurring basis are summarized in the following table by the type of inputs applicable to the fair value measurements (in thousands):

	Fair Value Measurement at October 7, 2018			
Description	**Total as of October 7, 2018**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Financial assets				
Other assets—cash and cash equivalents that fund supplemental executive retirement plan and deferred compensation plan	$ 546	$ 546	$ —	$ —
Other assets—assets that fund supplemental executive retirement plan	3,505	3,505	—	—
Other assets—deferred compensation plan investment in Sprouts and other	6,027	6,027	—	—
Financial liabilities				
Other long-term liabilities—deferred compensation plan	(19,951)	(2,553)	(17,398)	—
Total	$ (9,873)	$ 7,525	$ (17,398)	$ —

Level 1 Investments include money market funds of $0.5 million, market index funds of $3.5 million and an investment in Sprouts and other of $6.0 million with the corresponding deferred compensation liabilities of $2.6 million. The fair values of these investments are based on quoted market prices in an active market.

Level 2 Liabilities include $17.4 million of deferred compensation liabilities, the fair value of which is based on quoted prices of similar assets traded in active markets.

	Fair Value Measurement at December 31, 2017			
Description	**Total as of December 31, 2017**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Financial assets				
Other assets—cash and cash equivalents that fund supplemental executive retirement plan and deferred compensation plan	$ 540	$ 540	$ —	$ —
Other assets—assets that fund supplemental executive retirement plan	3,497	3,497	—	—
Other assets—deferred compensation plan investment in Sprouts	2,387	2,387	—	—
Derivatives	190	—	190	—
Financial liabilities				
Other long-term liabilities—deferred compensation plan	(18,938)	(2,268)	(16,670)	—
Total	$ (12,324)	$ 4,156	$ (16,480)	$ —

Level 1 Investments include money market funds of $0.5 million, market index funds of $3.5 million and an investment in Sprouts of $2.4 million with the corresponding deferred compensation liabilities of $2.3 million. The fair values of these investments are based on quoted market prices in an active market.

Level 2 Liabilities include $16.7 million of deferred compensation liabilities, the fair value of which is based on quoted prices of similar assets traded in active markets, and $0.2 million of derivatives, which are interest rate hedges. The fair values of the derivatives are determined based primarily on a third-party pricing model that applies observable credit spreads to each exposure to calculate a credit risk adjustment and the inputs are changed only when corroborated by observable market data.

Certain assets are measured at fair value on a nonrecurring basis, which means the assets are not measured at fair value on an ongoing basis but, rather, are subject to fair value adjustments only in certain circumstances (for example, when there is evidence of impairment). See Note 2, Summary of Significant Accounting Policies — Property, Plant and Equipment, Capitalized Software and Goodwill and Intangible Assets. The fair value measurements were determined using available market capitalization rates, estimated discounted cash flows and public company comparable market multiples data at the measurement dates. The Company classifies the measurements as Level 3.

6. Retirement Benefit Plans and Postretirement and Postemployment Benefit Obligations

Defined Benefit Retirement Plan

The Company has a funded noncontributory qualified defined benefit retirement plan (the "Single-Employer Plan") that, prior to June 1, 2008, covered substantially all full-time employees following a vesting period of five years of service (the "Pension Participants") and provided defined benefits based on years of service and final average salary. The Predecessor froze the accruing of future benefits for the majority of the Pension Participants (the "Frozen Pension Participants") effective June 1, 2008. As of October 7, 2018, there were approximately 450 hourly paid employees in the Company's distribution and transportation operations accruing future benefits under the plan and who remain eligible for pension benefits under the prior terms. No new employees are eligible for participation in the Single-Employer Plan after June 1, 2008, with the exception of new hires in the Company's distribution and transportation operations. After June 1, 2008 Frozen Pension Participants continued to accrue service for vesting purposes only and future payments from the Single-Employer Plan will be in accordance with the Single-Employer Plan's retirement payment provisions. The Company funds the Single-Employer Plan with annual contributions as required by the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Company uses a measurement date of December 31 for the Single-Employer Plan.

The components included in the net periodic benefit cost for the periods indicated are as follows (in thousands):

	Sixteen Weeks Ended		Forty Weeks Ended	
	October 7, 2018	October 8, 2017	October 7, 2018	October 8, 2017
Service cost	$ 700	$ 604	$ 1,564	$ 1,397
Interest cost	3,135	2,958	7,000	6,837
Expected return on plan assets	(3,735)	(3,117)	(8,341)	(7,204)
Amortization of net actuarial loss	67	191	149	441
Net periodic benefit cost	$ 167	$ 636	$ 372	$ 1,471

During the forty weeks ended October 7, 2018, the Company made a $8.9 million in contributions to the Single-Employer Plan. The Company's minimum required total contribution was approximately $8.8 million during fiscal year 2018. The Company does not expect to make any additional contributions in fiscal year 2018.

Supplemental Executive Retirement Plan

The Company maintains a noncontributory, nonqualified defined benefit supplemental executive retirement plan (the "SERP"), which provides supplemental income payments for certain current and former corporate officers in retirement. No new participants are eligible for participation and service and compensation accruals were frozen effective June 1, 2008. Accordingly, the retirement benefit for SERP participants who remained employed by the Company was frozen, and future service or compensation increases will not adjust the SERP benefit amount.

To provide partial funding for the SERP, the Company invests in corporate-owned life insurance policies. The Company uses a measurement date of December 31 for the SERP.

The components included in the net periodic benefit cost for the periods indicated are as follows (in thousands):

	Sixteen Weeks Ended		Forty Weeks Ended	
	October 7, 2018	October 8, 2017	October 7, 2018	October 8, 2017
Interest cost	$ 308	$ 336	$ 771	$ 839
Net periodic benefit cost	$ 308	$ 336	$ 771	$ 839

Postretirement and Postemployment Benefit Obligations

The Company provides health care benefits for certain retired employees. Prior to June 1, 2008, substantially all full-time employees could become eligible for such benefits if they reached retirement age while still working for the Company. The Company froze the accruing of benefits for eligible participants effective June 1, 2008. Participants who were eligible for a retiree medical benefit and retired prior to June 1, 2009 continued to be eligible for retiree medical coverage. The Company retains the right to make further amendments to the benefit formula and eligibility requirements. This postretirement health care plan is contributory with participants' contributions adjusted annually. The plan limits benefits to the lesser of the actual cost for the medical coverage selected or a defined dollar benefit based on years of service, applicable to eligible retirees. The Company uses a measurement date of December 31 for this health care plan.

The components included in the postretirement benefit cost for the periods indicated are as follows (in thousands):

	Sixteen Weeks Ended		Forty Weeks Ended	
	October 7, 2018	October 8, 2017	October 7, 2018	October 8, 2017
Service cost	$ 154	$ 154	$ 385	$ 385
Interest cost	185	185	462	462
Net periodic benefit cost	$ 339	$ 339	$ 847	$ 847

7. Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act ("Tax Act") was signed into law. The Tax Act includes a number of provisions, including (1) the lowering of the U.S. corporate tax rate from 35% to 21%; (2) elimination of the corporate alternative minimum tax (AMT); (3) the creation of the base erosion anti-abuse tax (BEAT, a new minimum tax), a general elimination of U.S. federal income taxes on dividends from foreign subsidiaries; (4) a new provision designed to tax global intangible low-taxed income (GILTI), which allows for the possibility of using foreign tax credits (FTCs) and a deduction of up to 50 percent to offset the income tax liability (subject to some limitations); (5) a new limitation on deductible interest expense; (6) the repeal of the domestic production activity deduction; and (7) limitations on the deductibility of certain executive compensation.

The Company's effective tax rate for the forty weeks ended October 7, 2018 and October 8, 2017 was 3.1% and 5.2%, respectively. The Company recorded income tax expense of $305,000 for the forty weeks ended October 7, 2018 on income before income taxes of $10.0 million. Income tax expense for the forty weeks ended October 7, 2018 was different than the U.S. federal statutory income tax rate of 21% primarily due to favorable "return-to-provision" adjustments and certain tax credits, partially offset by the unfavorable impact of the new executive compensation limitations, state income tax expense, stock option award exercises and vesting of restricted stock awards. The Company recorded income tax expense of $419,000 for the forty weeks ended October 8, 2017 on income before income taxes of $8.1 million. The income tax expense for the forty weeks ended October 8, 2017 was different than the U.S. federal statutory income tax rate of 35% primarily due to favorable excess tax benefits from stock option award exercises and restricted stock vesting, partially offset by the unfavorable impact of executive compensation limitations and state income tax expense.

On the enactment date of the Tax Act, the SEC issued Staff Accounting Bulletin No. 118 ("SAB 118") to address the application of U.S. GAAP in situations when a registrant does not have the necessary information available, prepared, or analyzed (including computations) in reasonable detail to complete the accounting for certain income tax effects of the Tax Act. As of December 31, 2017, the Company was able to reasonably estimate certain Tax Act effects and, therefore, recorded provisional adjustments associated with the deemed repatriation transition tax and remeasurement of certain deferred tax assets and liabilities. As of October 7, 2018, the Company finalized the accounting for the federal transition tax liability and recorded a measurement period adjustment for the change from our provisional estimate, which resulted in a tax benefit of $153,000. The Company's accounting for the Tax Act is incomplete for the remeasurement of deferred taxes and the previously disclosed provisional amount continues to be provisional and will be adjusted, if necessary, based on our ongoing analysis of the Tax Act and new regulatory guidance or other interpretations of the Tax Act. The accounting for this item must be completed within the measurement period defined by SAB 118, not longer than one year from the period in which the Tax Act was enacted.

The Company files income tax returns in the U.S. federal jurisdiction, various U.S. state jurisdictions and Mexico. The Company's federal tax return for the 2016 fiscal year was under examination by the Internal Revenue Service ("IRS") but this examination has been subsequently closed by the IRS. The Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2013. The tax years which remain subject to examination or are being examined by major tax jurisdictions as of October 7, 2018 include fiscal years 2013 through 2016 for state purposes and 2014, 2015, 2016 and 2017 for federal purposes.

8. Share-Based Compensation

2014 Incentive Plan

Effective September 23, 2014, and in connection with the IPO, SFSI adopted the Smart & Final Stores, Inc. 2014 Stock Incentive Plan (the "2014 Incentive Plan"). Effective March 13, 2017, the 2014 Incentive Plan was amended and restated to increase the number of shares that may be issued thereunder. The 2014 Incentive Plan provides for the issuance of equity-based incentive awards not to exceed 9,200,000 shares of Common Stock to eligible employees, consultants and non-employee directors in the form of stock options, restricted stock, other stock-based awards and performance-based cash awards. In addition, a number of shares of Common Stock equal to the number of shares of Common Stock underlying stock options that were previously issued under the 2012 Incentive Plan (as defined below) and that expire, terminate or are cancelled for any reason without being exercised in full will be available for issuance under the 2014 Incentive Plan.

On May 7, 2018, May 14, 2018 and July 30, 2018, the compensation committee of SFSI's board of directors (the "Compensation Committee") granted a total of 1,370,576 shares of restricted stock to certain management employees and non-employee directors under the 2014 Incentive Plan. These awards have time-based vesting terms subject to continuous employment with the Company. Except for the shares granted to non-employee directors, which vest in full one year from May 14, 2018, these awards vest in equal tranches of one-third each year over a three-year period on dates established by the Compensation Committee. During the forty weeks ended October 7, 2018, 112,880 shares of restricted stock were surrendered to the Company to cover the grantee's income tax obligations in connection with the vesting of restricted stock awards.

The following table summarizes the restricted stock award activity under the 2014 Incentive Plan for the forty weeks ended October 7, 2018:

	Shares	Weighted-Average Grant Date Fair Value
Outstanding at December 31, 2017	1,954,604	$ 11.38
Granted	1,370,576	4.97
Forfeited	(25,334)	9.59
Vested	(543,988)	13.04
Outstanding at October 7, 2018	2,755,858	$ 7.88

The Company recorded share-based compensation expense related to the restricted stock awards of $2.9 million and $2.6 million for the sixteen weeks ended October 7, 2018 and October 8, 2017, respectively, and $7.8 million and $5.0 million for the forty weeks ended October 7, 2018 and October 8, 2017, respectively. As of October 7, 2018, the unrecognized compensation cost was $12.4 million and related weighted-average period over which restricted stock award expense was expected to be recognized was approximately 1.73 years.

On July 30, 2018, the Committee granted stock options to purchase up to a total of 12,593 shares of Common Stock to a certain management employee under the 2014 Incentive Plan. These awards vest in equal installments of 25% each year over a four-year period from dates established by the Committee subject to continuous employment with the Company.

The following table summarizes the time-based option activity under the 2014 Incentive Plan for the forty weeks ended October 7, 2018 (dollars in thousands except weighted average exercise price):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2017	3,254,544	$ 12.89	7.67 years	$ —
Granted	12,593	5.95		
Forfeited	(54,652)	12.54		
Exercised	—	—		
Expired	(14,656)	13.26		
Outstanding at October 7, 2018	3,197,829	$ 12.86	6.92 years	$ —
Exercisable at October 7, 2018	1,945,169	$ 12.65	6.47 years	$ —

Aggregate intrinsic value represents the difference between the closing stock price of the Common Stock and the exercise price of outstanding, in-the-money options. The Company's ticker symbol on the New York Stock Exchange is SFS.

The Company recorded share-based compensation expense for time-based options granted under the 2014 Incentive Plan of $0.7 million and $1.3 million for the sixteen weeks ended October 7, 2018 and October 8, 2017, respectively, and $2.3 million and $2.8 million for the forty weeks ended October 7, 2018 and October 8, 2017, respectively. As of October 7, 2018, the unrecognized compensation cost was $2.2 million and related weighted-average period over which time-based option expense was expected to be recognized was approximately 1.38 years.

2012 Incentive Plan

Effective November 15, 2012, SFSI adopted the SF CC Holdings, Inc. 2012 Stock Incentive Plan (the "2012 Incentive Plan"), which provides for the issuance of equity-based incentive awards not to exceed 11,400,000 shares of Common Stock. Effective upon closing of the IPO, no new awards may be granted under the 2012 Incentive Plan.

The following table summarizes the time-based option activity under the 2012 Incentive Plan for the forty weeks ended October 7, 2018 (dollars in thousands except weighted average exercise price):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2017	4,482,570	$ 6.58	5.10 years	$ 8,809
Forfeited	—	—		
Exercised	(110,922)	5.27		
Cancelled	—	—		
Expired	(67,260)	6.59		
Outstanding at October 7, 2018	4,304,388	$ 6.62	4.33 years	$ —
Exercisable at October 7, 2018	4,304,388	$ 6.62	4.33 years	$ —

The Company recorded share-based compensation expense for time-based options granted under the 2012 Incentive Plan of $0 and $0.3 million for the sixteen weeks ended October 7, 2018 and October 8, 2017, respectively, and $0.1 million and $0.6 million for the forty weeks ended October 7, 2018 and October 8, 2017, respectively. As of October 7, 2018, there was no unrecognized compensation cost.

In connection with the Ares Acquisition on November 15, 2012, certain stock options to purchase shares of common stock of the Predecessor were converted into 3,625,580 stock options to purchase Common Stock (the "Rollover Options"). In the event of a participant's termination of employment for cause or upon discovery that the participant engaged in detrimental activity, if the Company elected to exercise its repurchase right, it was required to do so within a 180-day period commencing on the later of (i) the date of termination and (ii) the date on which such Rollover Option was exercised. In the event of a participant's termination of employment for any other reason, the repurchase right was required to be exercised by the Company during the 90-day period following the date of termination.

The following table summarizes the Rollover Option activity for the forty weeks ended October 7, 2018 (dollars in thousands except weighted average exercise price):

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at December 31, 2017	1,127,920	$ 2.50	0.99 years	
Forfeited	—	—		
Exercised	(524,466)	2.48		
Cancelled	—	—		
Expired	—	—		
Outstanding at October 7, 2018	603,454	$ 2.51	0.25 years	$ —
Exercisable at October 7, 2018	603,454	$ 2.51	0.25 years	$ —

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9. Accumulated Other Comprehensive Loss

The following table represents the changes in AOCL by each component for the forty weeks ended October 7, 2018 (in thousands):

	Defined Benefit Retirement Plan	Cash Flow Hedging Activity	Foreign Currency Translation and Employee Benefit Obligation Adjustment	Total
Balance at December 31, 2017	$ (22,776)	$ 101	$ (2,291)	$ (24,966)
OCI before reclassification	—	(138)	(420)	(558)
Amounts reclassified out of AOCL	—	15	—	15
Net current period OCI	—	(123)	(420)	(543)
Balance at October 7, 2018	$ (22,776)	$ (22)	$ (2,711)	$ (25,509)

The following table represents the items reclassified out of each component of AOCL and the related tax effects for the forty weeks ended October 7, 2018 (in thousands):

Details about AOCL Components	Amount Reclassified from AOCL	Location within Statement of Operations and Comprehensive Income
Income on cash flow hedges		
Interest rate swaps	$ 21	Interest income (expense)
	21	Total before income taxes
	(6)	Income tax (provision) benefit
	$ 15	Reclassification of adjustments, net of tax
Total reclassifications for the forty weeks ended October 7, 2018	$ 15	Total reclassifications, net of tax

10. Segment Information

The Company is a value-oriented retailer serving a diverse demographic of household and business customers through two complementary store banners. The “Smart & Final” business focuses on both household and business customers, and the “Smart Foodservice” business focuses primarily on restaurants, caterers and a wide range of other foodservice businesses. The Company’s chief operating decision maker (“CODM”) regularly reviews the operating performance of each of the store banners including measures of performance based on income (loss) from operations. The Company considers each of the store banners to be an operating segment and has further concluded that presenting disaggregated information of these two operating segments provides meaningful information as certain economic characteristics are dissimilar as well as the characteristics of the customer base served.

The “Corporate/Other” category is comprised primarily of corporate overhead support expenses and administrative expenses incidental to the activities of the reportable segments, interest expense and other costs associated with the Company’s debt obligations, equity earnings in its joint venture, and income taxes.

For the sixteen weeks ended October 7, 2018, the operating information and total assets for the reportable segments are as follows (in thousands):

	Smart & Final	Smart Foodservice	Corporate / Other	Consolidated
Net sales	$ 1,144,090	$ 353,579	$ —	$ 1,497,669
Cost of sales, distribution and store occupancy	961,575	300,999	2,646	1,265,220
Operating and administrative expenses	159,742	25,660	24,488	209,890
Income (loss) from operations	$ 22,773	$ 26,920	$ (27,134)	$ 22,559
As of October 7, 2018:				
Total assets	$ 1,695,259	$ 458,194	$ (324,894)	$ 1,828,559
Intercompany receivable (payable)	$ 289,544	$ 76,258	$ (365,802)	$ —
Investment in joint venture	$ —	$ —	$ 16,746	$ 16,746
Goodwill	$ 181,338	$ 204,580	$ —	$ 385,918
For the sixteen weeks ended October 7, 2018:				
Capital expenditures	$ 27,747	$ 6,759	$ 7,806	$ 42,312
Depreciation and amortization	$ 25,899	$ 1,682	$ 2,248	$ 29,829

For the sixteen weeks ended October 8, 2017, the operating information and total assets for the reportable segments are as follows (in thousands):

	Smart & Final	Smart Foodservice	Corporate / Other	Consolidated
Net sales	$ 1,115,234	$ 342,119	$ —	$ 1,457,353
Cost of sales, distribution and store occupancy	948,476	292,502	2,512	1,243,490
Operating and administrative expenses	145,410	23,972	25,903	195,285
Income (loss) from operations	$ 21,348	$ 25,645	$ (28,415)	$ 18,578
For the sixteen weeks ended October 8, 2017:				
Capital expenditures	$ 38,699	$ 5,201	$ 4,201	$ 48,101
Depreciation and amortization	$ 26,962	$ 1,698	$ 2,391	$ 31,051

For the forty weeks ended October 7, 2018, the operating information for the reportable segments is as follows (in thousands):

	Smart & Final	Smart Foodservice	Corporate / Other	Consolidated
Net sales	$ 2,807,739	$ 831,651	$ —	$ 3,639,390
Cost of sales, distribution and store occupancy	2,374,313	710,016	6,633	3,090,962
Operating and administrative expenses	385,179	62,329	60,384	507,892
Income (loss) from operations	$ 48,247	$ 59,306	$ (67,017)	$ 40,536
For the forty weeks ended October 7, 2018:				
Capital expenditures	$ 76,783	$ 14,990	$ 15,964	$ 107,737
Depreciation and amortization	$ 66,403	$ 4,480	$ 5,363	$ 76,246

For the forty weeks ended October 8, 2017, the operating information for the reportable segments is as follows (in thousands):

	Smart & Final	Smart Foodservice	Corporate / Other	Consolidated
Net sales	$ 2,716,337	$ 786,320	$ —	$ 3,502,657
Cost of sales, distribution and store occupancy	2,311,878	675,007	6,528	2,993,413
Operating and administrative expenses	357,112	57,579	59,330	474,021
Income (loss) from operations	$ 47,347	$ 53,734	$ (65,858)	$ 35,223
For the forty weeks ended October 8, 2017:				
Capital expenditures	$ 93,503	$ 11,575	$ 12,505	$ 117,583
Depreciation and amortization	$ 64,982	$ 3,975	$ 6,091	$ 75,048

11. Commitments and Contingencies

Legal Actions

The Company is engaged in various legal actions, claims and proceedings in the ordinary course of business, including claims related to employment related matters, breach of contracts, products liabilities and intellectual property matters resulting from its business activities. The Company does not believe that the ultimate resolution of these pending claims will have a material adverse effect on its business, financial condition, results of operations and cash flows. However, litigation is subject to many uncertainties, and the outcome of certain individual litigated matters may not be reasonably predictable and any related damages may not be estimable. Some litigation matters could result in an adverse outcome to the Company, and any such adverse outcome could have a material adverse effect on its business, financial condition, results of operations and cash flows.

12. Earnings Per Share

Basic earnings per share represents net income for the period shares of Common Stock were outstanding, divided by the weighted average number of shares of Common Stock outstanding for the applicable period. Diluted earnings per share represents net income divided by the weighted average number of shares of Common Stock outstanding for the applicable period, inclusive of the effect of dilutive securities such as outstanding stock options and unvested restricted stock.

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

	Sixteen Weeks Ended		Forty Weeks Ended	
	October 7, 2018	October 8 2017	October 7, 2018	October 8, 2017
Net income	$ 10,160	$ 5,106	$ 9,667	$ 7,642
Weighted average shares outstanding for basic EPS	73,117,389	72,446,404	72,713,906	72,437,033
Effect of dilutive securities:				
Assumed exercise of time-based stock options and vesting of restricted stock	1,329,271	1,806,970	1,357,798	3,151,149
Weighted average shares and share equivalents outstanding for diluted EPS	74,446,660	74,253,374	74,071,704	75,588,182
Basic earnings per share	$ 0.14	$ 0.07	$ 0.13	$ 0.11
Diluted earnings per share	$ 0.14	$ 0.07	$ 0.13	$ 0.10

Potentially dilutive securities representing 6,301,675 shares of Common Stock for the sixteen weeks ended October 7, 2018 and 6,441,045 shares of Common Stock for the sixteen weeks ended October 8, 2017 were excluded from the computation of diluted earnings per share because their effect would have been antidilutive. Potentially dilutive securities representing 6,501,271 shares of Common Stock for the forty weeks ended October 7, 2018 and 3,623,034 shares of Common Stock for the forty weeks ended October 8, 2017 were excluded from the computation of diluted earnings per share because their effect would have been antidilutive.

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 should be read in conjunction with Item 1, "Financial Statements" in Part I of this quarterly report on Form 10-Q.

Forward-Looking Statements

The discussion in this quarterly report, including under Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I and Item 1A, "Risk Factors" of Part II, contains forward-looking statements within the meaning of federal securities laws. All statements other than statements of historical fact contained in this quarterly report, including statements regarding our future operating results and financial position, business strategy and plans and objectives of management for future operations, are forward-looking statements. In many cases, you can identify forward-looking statements by terms such as "may," "should," "expects," "plans," "anticipates," "could," "intends," "target," "projects," "contemplates," "believes," "estimates," "predicts," "potential" or "continue" or the negative of these terms or other similar expressions.

The forward-looking statements contained in this quarterly report reflect our views as of the date hereof about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause our actual results, performance or achievements to differ significantly from those expressed or implied in any forward-looking statement. Although we believe that the expectations reflected in the forward-looking statements in this quarterly report are reasonable, we cannot guarantee future events, results, performance or achievements. A number of important factors could cause actual results to differ materially from those indicated by the forward-looking statements in this quarterly report, including, without limitation, those factors described in Item 2, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of Part I and Item 1A, "Risk Factors" of Part II. Some of the key factors that could cause actual results to differ from our expectations include the following:

- competition in our industry is intense and our failure to compete successfully may adversely affect our sales, financial condition and operating results;
- our growth depends in part on new store openings and our failure to successfully open new stores or successfully manage the potential difficulties associated with store growth could adversely affect our business and stock price;
- we may be unable to maintain or increase comparable store sales, which could adversely affect our business and stock price;

- real or perceived quality or food safety concerns could adversely affect our business, operating results and reputation;
- inflation and deflation can impact our net sales, inventory, costs of goods sold and gross margin and operating leverage;
- the current geographic concentration of our stores and net sales creates an exposure to local or regional downturns or catastrophic occurrences;
- if we are unable to attract, train and retain, or maintain satisfactory relations with, our employees could impact our ability to grow or successfully operate our business;
- disruption of supplier relationships could adversely affect our business;
- changes in commodity prices and availability may affect our financial condition and operating results;
- any significant interruption in the operations of our distribution centers or common carriers could disrupt our ability to deliver our products in a timely manner;
- our failure to comply with laws, rules and regulations affecting us and our industry could adversely affect our financial condition and operating results;
- disruptions to or security breaches involving our information technology systems, including disruptions related to implementation of new systems or enhancements to existing systems, could harm our ability to run our business;
- we have significant debt service obligations and may incur additional indebtedness in the future, which could adversely affect our financial condition and operating results and our ability to react to changes to our business;
- covenants in our debt agreements restrict our operational flexibility; and
- if our goodwill becomes impaired, we may be required to record a significant charge to earnings.

Readers are urged to consider these factors carefully in evaluating the forward-looking statements in this quarterly report and are cautioned not to place undue reliance on these forward-looking statements. All of the forward-looking statements in this quarterly report are based on information available to us on the date hereof. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as otherwise required by law.

Business Overview

We are a value-oriented food retailer serving a diverse and dynamic demographic of household and business customers through two complementary and highly productive store banners. Our *Smart & Final* stores focus on both household and business customers, and our *Smart Foodservice* (formerly known as *Cash & Carry Smart Foodservice*) stores focus primarily on business customers. As of October 7, 2018, we operated 324 convenient, non-membership, smaller-box, warehouse-style stores throughout the Western United States, with an additional 15 stores in Northwestern Mexico operated through a joint venture. We have a differentiated merchandising strategy that emphasizes high quality perishables, a wide selection of private label products, products tailored to business and foodservice customers and products offered in a broad range of product sizes, all at “everyday low prices.”

As of October 7, 2018, we operated 260 *Smart & Final* stores in California, Arizona and Nevada, which offer extensive selections of fresh perishables and everyday grocery items, together with a targeted selection of foodservice, packaging and janitorial products, under both national and private label brands. Customers can choose from a broad range of product sizes, including an assortment of standard-sized products typically found at conventional grocers, and a large selection of larger sized offerings (including uniquely sized national brand products) more typical of warehouse club style stores. Pricing in our *Smart & Final* stores is targeted to be substantially lower than that of conventional grocers and competitive with that of large discount store operators and warehouse clubs. We believe we offer higher quality produce at lower prices than typically found at large discounters. We also believe our *Smart & Final* stores provide a better everyday value to household and business customers than typical warehouse clubs by offering greater product selection at competitive prices, with no membership fee requirement, in a convenient, easy-to-shop format.

Within the *Smart & Final* banner we operate both *Extra!* and legacy *Smart & Final* stores. Beginning in late 2008, we launched an initiative to convert our larger legacy *Smart & Final* stores to our *Extra!* format. With a larger store footprint and an expanded merchandise selection, our *Extra!* format offers a one-stop shopping experience with over 16,000 SKUs, over 4,000 more SKUs than our legacy *Smart & Final* stores, with an emphasis on perishables and household items. As of October 7, 2018, we operated 199 Extra! stores of which 104 represent conversions or relocations of legacy *Smart & Final* stores and 95 represent new store openings. In recent years we have significantly increased the number of *Extra!* stores, facilitated primarily by our acquisition of a dedicated perishables warehouse, our acquisition of a group of stores in fiscal year 2016, and by our continued investments in distribution capabilities and in-store merchandising. The continued development of our *Extra!* store format, through additional new store openings and expansions and relocations of legacy *Smart & Final* stores to the *Extra!* store format, is expected to be the cornerstone of future *Smart & Final* banner growth.

As of October 7, 2018, we also operated 64 *Smart Foodservice* stores focused primarily on restaurants, caterers and a wide range of other foodservice businesses such as food trucks and coffee houses. We offer customers the opportunity to shop for their everyday foodservice needs in a convenient, no-frills warehouse shopping environment. These stores are located in Washington, Oregon, Northern California, Idaho, Montana, Nevada and Utah. Pricing in our *Smart Foodservice* stores is targeted to be substantially lower than that of our foodservice delivery competitors, with greater price transparency to customers and no minimum order size. Pricing is also competitive with typical warehouse clubs, with no membership fee requirement. Since late 2014, we have opened 12 new *Smart Foodservice* stores in existing and new market areas, and are actively pursuing additional growth opportunities for this store banner.

In both store banners, we are actively investing in increasing online sales, including both direct delivery to customers through partner services and using buy online, pick up in store models. As of October 7, 2018, we offered direct delivery or pick up in store options across nearly our entire geographic footprint and fulfil these orders in over 98% of our *Smart & Final* stores and *Smart Foodservice* stores.

We believe that our “everyday low prices”, unique merchandising strategy and convenient locations enable us to offer a differentiated food shopping experience with broad appeal to a diverse and dynamic customer demographic.

Outlook

We plan to expand our store footprint, primarily through opening new *Extra!* stores in existing and adjacent markets, and over time by entering new markets. We believe we have a scalable operating infrastructure to support our anticipated growth which, together with our flexible real estate strategy and advanced distribution capabilities, position us to capitalize on our growth opportunities. During the first three quarters of 2018 we opened three new *Extra!* stores, relocated two legacy *Smart & Final* stores to *Extra!* format stores and did not convert any legacy *Smart & Final* stores to *Extra!* format stores. Our 2018 store development plans anticipate one additional new *Extra!* store. We plan to opportunistically continue to expand our larger legacy *Smart & Final* stores to our *Extra!* format and invest in our legacy *Smart & Final* stores that are not candidates for conversion to the *Extra!* format by completing major remodel projects and targeted relocations. We also plan to open two additional *Smart Foodservice* stores in 2018.

In 2019, we plan to open two to three additional *Smart & Final Extra!* stores and relocate or expand up to three legacy *Smart & Final* stores to *Extra!* format stores. We also plan to open four to five new *Smart Foodservice* stores in 2019.

In addition, we plan to leverage our significant investments in management, information technology systems, infrastructure and marketing to grow our comparable store sales and enhance our operating margins through execution of a number of key initiatives, including initiatives to increase net sales of perishable products in our *Smart & Final* stores, to increase net sales of private label products in our *Smart & Final* and *Smart Foodservice* stores, and to expand our marketing programs in our *Smart & Final* and *Smart Foodservice* stores. We expect each of these key initiatives, if successful, to generate increased comparable store sales and also expect our initiative to increase net sales of private label products to enhance our operating margins, as private label products have historically generated higher gross margins relative to national branded products.

Factors Affecting Our Results of Operations

Store Openings

We expect that a primary driver of our growth in sales and gross margin will be the continued development of our *Extra!* format stores through new store openings and expansions and relocations. We also plan to opportunistically open new *Smart Foodservice* stores, which will further amplify sales and gross margin. Our results of operations have been and will continue to be materially affected by the timing and number of new store openings, including conversions and relocations of legacy *Smart & Final* stores to the *Extra!* format, and the amount of associated costs. For example, we typically incur higher than normal employee costs at the time of a new store opening, conversion or relocation associated with set-up and other related costs. Also, our operating margins are typically negatively affected by promotional discounts and other marketing costs associated with new store openings, conversions and relocations, as well as higher inventory markdowns and costs related to hiring and training new employees in new stores. Additionally, promotional activities may result in higher than normalized sales in the first several weeks following a new store opening. Our new *Extra!* and *Smart Foodservice* stores typically build a customer base over time and reach a mature sales growth rate in the third and fourth year after opening, respectively. As a result, our new stores generally have lower margins and higher operating expenses, as a percentage of sales, than our more mature stores.

Based on our experience, we expect that certain of our new *Extra!* stores will impact sales at our existing stores in close proximity in the short-term. However, we believe that over the longer term any such sales impact will be more than offset by future sales growth and expanded market share.

Developments in Competitive Landscape

We operate in the highly competitive U.S. food retail and foodservices industry. We compete on a combination of factors, including price, product selection, product quality, convenience, customer service, store format and location, and digital commerce options. Our principal competitors include conventional grocers such as Albertsons/Safeway and Kroger, warehouse clubs and discounters such as Costco and Aldi, mass merchandisers such as Walmart and Target, foodservice delivery companies such as Sysco and US Foods, online retailers such as Amazon, as well as other specialty stores. Some of our competitors may have greater financial or marketing resources than we do and may be able to devote greater resources to sourcing, promoting and selling their products. These competitors could use these advantages to take certain measures, including reducing prices that could adversely affect our competitive position, business, financial condition and operating results.

Pricing Strategy and Investments in "Everyday Low Prices"

We have a commitment to "everyday low prices", which we believe positions both our *Smart & Final* and *Smart Foodservice* stores as top of mind destinations for our target customers. Pricing in our *Smart & Final* stores is targeted to be substantially lower than that of conventional grocers and competitive with that of large discounters and warehouse clubs, with no membership fee requirement. Pricing in our *Smart Foodservice* stores is targeted to be substantially lower than our foodservice delivery competitors, with no membership fee requirement and greater price transparency to customers with no minimum order size, and competitive with typical warehouse clubs.

Our pricing strategy is geared toward optimizing the pricing and promotional activities across our mix of higher-margin perishable items and everyday value-oriented traditional grocery items. This strategy involves determining prices that will improve our operating margins based upon our analysis of how demand varies at different price levels as well as our costs and inventory levels.

Private Label Products

Private label products are key components of our pricing and merchandising strategy, as we believe they build and deepen customer loyalty, enhance our value proposition, generate higher gross margins relative to national brands and improve the breadth and selection of our product offering. We believe that a strong private label offering has become an increasingly important competitive advantage in the food retail and foodservices industries.

As of October 7, 2018, we had a portfolio of approximately 3,100 private label items, which represented 28% of our *Smart & Final* banner sales for the forty weeks ended October 7, 2018. Typically, our private label products generate a higher gross margin as a percentage of sales as compared to a comparable national brand product.

General Economic Conditions and Changes in Consumer Behavior

The overall economic environment in the markets we serve, particularly California, and related changes in consumer behavior, have a significant impact on our business and results of operations. In general, positive conditions in the broader economy promote customer spending in our stores, while economic weakness results in reduced customer spending. Macroeconomic factors that can affect customer spending patterns, and thereby our results of operations, include employment rates, business conditions, changes in the housing market, the availability of consumer credit, interest rates, tax rates and fuel and energy costs.

Infrastructure Investment

Our historical results of operations reflect the impact of our ongoing investments in infrastructure to support our growth. We have made significant investments in senior management, information technology systems, supply chain systems and marketing. These investments include significant additions to our personnel, including experienced industry executives and management and merchandising teams to support our long-term growth objectives. We plan on continuing to make targeted investments in our infrastructure as necessary to support our growth.

Inflation and Deflation Trends

Inflation and deflation can impact our financial performance. During inflationary periods, our results of operations can be positively impacted as we sell lower-priced inventory in a higher price environment. In contrast, food deflation could negatively impact our results of operations by reducing sales growth and earnings if our competitors react by lowering their retail pricing. The short-term impact of inflation and deflation is largely dependent on whether or not we pass the effects through to our customers, which is subject to competitive market conditions. In recent inflationary periods, we have generally been able to pass through most cost increases. Beginning in the second quarter of fiscal year 2015 and continuing through the first quarter of fiscal year 2017, we experienced deflation in certain food and non-food commodities. Market dynamics caused us to pass cost decreases through to customers, which negatively impacted sales growth and income from operations in certain categories, primarily in proteins, but also in high volume categories like cheese and fresh produce. In the second quarter of fiscal year 2017, we began to experience modest inflation in some of the food and non-food products we sell, which continued through the second quarter of fiscal year 2018. In the third quarter of fiscal year 2018 deflation in certain food and non-food commodities returned, and we expect such deflation to continue for the remainder of fiscal year 2018.

Components of Results of Operations

Net Sales

We recognize revenue from the sale of products at the point of sale. Discounts provided to customers at the time of sale are recognized as a reduction in sales as the products are sold. Sales tax collections are presented in the statement of operations and comprehensive income on a net basis and, accordingly, are excluded from reported sales revenues. Proceeds from the sale of our *Smart & Final* gift cards are recorded as a liability at the time of sale, and recognized as sales when they are redeemed by the customer. Our *Smart & Final* gift cards do not have an expiration date.

We regularly review and monitor comparable store sales growth to evaluate and identify trends in our sales performance. With respect to any fiscal period during any year, comparable store sales include sales for stores operating both during such fiscal period in such year and in the same fiscal period of the previous year. Sales from a store will be included in the calculation of comparable store sales after the 60th full week of operations, and sales from a store are also included in the calculation of comparable store sales if (i) the store has been physically relocated, (ii) the selling square footage has been increased or decreased or (iii) the store has been converted to a new format within a store banner (e.g., from a legacy *Smart & Final* store to the *Extra!* format).

Cost of Sales, Buying and Occupancy and Gross Margin

The major categories of costs included in cost of sales, buying and occupancy are cost of goods sold, distribution costs, costs of our buying department and store occupancy costs, net of earned vendor rebates and other allowances. Distribution costs consist of all warehouse receiving and inspection costs, warehousing costs, all transportation costs associated with shipping goods from our warehouses to our stores, and other costs of our distribution network. Store occupancy costs include store rental, common area maintenance, property taxes, property insurance, and depreciation.

Gross margin represents sales less cost of sales, buying and occupancy. Our gross margin may not be comparable to other retailers, since not all retailers include all of the costs related to their distribution network in cost of sales like we do. Some retailers exclude a portion of these costs (e.g., store occupancy and buying department costs) from cost of sales and include them in selling, general and administrative expenses.

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

Operating and Administrative Expenses

Operating and administrative expenses include direct store-level expenses associated with displaying and selling our products at the store level, including salaries and benefits for our store work force, fringe benefits, store supplies, advertising and marketing and other store-specific costs. Operating and administrative expenses also consist of store overhead costs and corporate administrative costs including salaries and benefits costs, share-based compensation, corporate occupancy costs, amortization expense, and other expenses associated with being a public company.

We expect that our operating and administrative expenses will increase in future periods resulting from our store development program, including the growth in the number of our stores and as a result of additional legal, accounting, insurance and other expenses associated with being a public company.

Income Tax Provision

We are subject to federal income tax as well as state income tax in various jurisdictions of the United States in which we conduct business. Income taxes are accounted for under the asset and liability method.

Equity in Earnings of Mexico Joint Venture

Our wholly owned subsidiary, Smart & Final de Mexico S.A. de C.V., is a Mexican holding company that owns a 50% interest in a joint venture. The remaining 50% of the joint venture is owned by Grupo Calimax S.A. de C.V., an entity comprising the investment interests of a family group who are also the owners of the Calimax grocery store chain in Mexico. As of October 7, 2018, this joint venture operated 15 *Smart & Final* stores in Northwestern Mexico, which are similar in concept to our legacy *Smart & Final* stores. This joint venture operates as a Mexican domestic corporation under the name Smart & Final del Noroeste, S.A. de C.V. Our interest in this joint venture is not consolidated and is reported using the equity method of accounting.

Factors Affecting Comparability of Results of Operations

Term Loan Facility and Revolving Credit Facility

Our interest expense in any particular period is impacted by our overall level of indebtedness during that period and by changes in the applicable interest rates on such indebtedness.

2017 Tax Cuts and Jobs Act

On December 22, 2017, the Tax Act was enacted into law, which changed various corporate federal income tax provisions of the Internal Revenue Code. Substantially all the provisions of the Tax Act are effective for taxable years beginning after December 31, 2017. We expect that the most significant changes that will impact the Company are the reduction in the corporate federal income tax rate from 35% to 21% and 100% bonus depreciation for qualified property acquired and placed in service after September 27, 2017 and before January 1, 2023. In a manner consistent with ASC 740-10-25-47, the effect of a change in tax law or rates shall be recognized at the date of enactment. Accordingly, the Company accounted for the corporate federal income tax rate reduction in the fourth quarter of 2017 (see Note 7, Income Taxes, in the accompanying notes to our consolidated financial statements).

Basis of Presentation

Our fiscal year is the 52- or 53-week period ending on the Sunday closest to December 31. Each of our 52-week fiscal years consists of twelve-week periods in the first, second and fourth quarters of the fiscal year and a sixteen-week period in the third quarter. Our last completed fiscal year ended on December 31, 2017 and was a 52-week period.

Results of Operations

The following table summarizes key components of our results of operations for the periods indicated, both in dollars and as a percentage of sales.

Consolidated Statements of Operations Data

	Sixteen Weeks Ended				Forty Weeks Ended			
	October 7, 2018		October 8, 2017		October 7, 2018		October 8, 2017	
	(Dollars in thousands, except per share)							
Net sales	$1,497,669	100.0%	$1,457,353	100.0%	$3,639,390	100.0%	$3,502,657	100.0%
Cost of sales, buying and occupancy	1,265,220	84.5%	1,243,490	85.3%	3,090,962	84.9%	2,993,413	85.5%
Gross margin	232,449	15.5%	213,863	14.7%	548,428	15.1%	509,244	14.5%
Operating and administrative expenses	209,890	14.0%	195,285	13.4%	507,892	14.0%	474,021	13.5%
Income from operations	22,559	1.5%	18,578	1.3%	40,536	1.1%	35,223	1.0%
Interest expense, net	13,250	0.8%	11,229	0.8%	32,165	0.8%	27,738	0.8%
Equity in earnings of joint venture	651	—%	362	—%	1,601	—%	576	—%
Income before income taxes	9,960	0.7%	7,711	0.5%	9,972	0.3%	8,061	0.2%
Income tax benefit (provision)	200	0.0%	(2,605)	(0.1)%	(305)	0.0%	(419)	0.0%
Net income	$ 10,160	0.7%	$ 5,106	0.4%	$ 9,667	0.3%	$ 7,642	0.2%
Per Share Data:								
Earnings per share:								
Net income per share - Basic	$ 0.14		$ 0.07		$ 0.13		$ 0.11	
Net income per share - Diluted	$ 0.14		$ 0.07		$ 0.13		$ 0.10	

Other Operating Data

Comparable store sales growth	0.6%	1.5%	1.0%	0.4%
Smart & Final banner	0.2%	1.0%	0.3%	0.1%
Smart Foodservice banner	2.0%	3.4%	3.4%	1.3%
Stores at end of period	324	316	324	316
Smart & Final banner	260	253	260	253
Extra! format	199	183	199	183
Smart Foodservice banner	64	63	64	63

Sixteen Weeks Ended October 7, 2018 Compared to the Sixteen Weeks Ended October 8, 2017

Net Sales

Net sales for the sixteen weeks ended October 7, 2018 increased $40.3 million, or 2.8%, to $1,497.7 million as compared to $1,457.4 million for the sixteen weeks ended October 8, 2017. This increase in net sales was attributable to net sales of $31.3 million from the opening of eleven new stores since third quarter 2017 and a comparable store sales increase of $9.0 million in our store banners.

For the sixteen weeks ended October 7, 2018, comparable store sales increased 0.6% as compared to the sixteen weeks ended October 8, 2017. This increase in comparable store sales was attributable to an increase in comparable average transaction size of 1.9% partially offset by a decrease in comparable transaction count of 1.3%.

For the sixteen weeks ended October 7, 2018, net sales for our *Smart & Final* segment increased $28.9 million, or 2.6%, to $1,144.1 million as compared to $1,115.3 million for the sixteen weeks ended October 8, 2017. Comparable store sales for our *Smart & Final* segment increased 0.2% as compared to the sixteen weeks ended October 8, 2017. This increase in comparable store sales was attributable to an increase in comparable average transaction size of 1.6% partially offset by a decrease in comparable transaction count of 1.4%.

For the sixteen weeks ended October 7, 2018, net sales for our *Smart Foodservice* segment increased $11.5 million, or 3.3%, to $353.6 million as compared to $342.1 million for the sixteen weeks ended October 8, 2017. Comparable store sales for our *Smart Foodservice* segment increased 2.0% as compared to the sixteen weeks ended October 8, 2017. This increase in comparable store sales was attributable to an increase in comparable average transaction size of 2.1% partially offset by a decrease in comparable transaction count of 0.2%.

As a result of our store growth in existing markets, we also have experienced sales transfer from certain existing stores to new stores. In comparable store sales, we believe that the principal effect of this sales transfer is evidenced in the comparable sales transaction count.

Gross Margin

Gross margin for the sixteen weeks ended October 7, 2018 increased $18.6 million, or 8.7%, to $232.4 million as compared to $213.9 million for the sixteen weeks ended October 8, 2017. The increase in gross margin attributable to increased sales was $5.9 million, and $12.7 million was attributable to increased gross margin rate. As a percentage of sales, gross margin was 15.5% for the sixteen weeks ended October 7, 2018 as compared to 14.7% for the sixteen weeks ended October 8, 2017. Compared to the sixteen weeks ended October 8, 2017, gross margin as a percentage of sales for the sixteen weeks ended October 7, 2018 included higher merchandise product margin rates (including the effect of inventory losses) as a percentage of sales, accounting for an increase of 0.93% (consisting of a 0.82% increase related to our *Smart & Final* segment, and a 0.11% increase related to our *Smart Foodservice* segment). Warehouse and transportation costs as a percentage of sales increased 0.12% (representing a 0.11% increase related to our *Smart & Final* segment and a 0.01% increase related to our *Smart Foodservice* segment). Store occupancy costs as a percentage of sales decreased 0.04% (consisting of a decrease of 0.03% related to our *Smart & Final* segment and a 0.01% decrease related to our *Smart Foodservice* segment). This decrease in our *Smart & Final* segment included a decrease of 0.12% related to stores locations opened prior to 2015, partially offset by a 0.09% increase related to stores opened in 2015 through third quarter 2017.

Operating and Administrative Expenses

Operating and administrative expenses for the sixteen weeks ended October 7, 2018 increased $14.6 million, or 7.5%, to $209.9 million, as compared to $195.3 million for the sixteen weeks ended October 8, 2017. The increase in operating and administrative expenses was primarily due to $9.7 million increase in wages, fringe benefits and incentive bonus costs, $4.5 million increase in other store direct expenses, $0.3 million increase in marketing costs, $0.8 million increase in expense associated with cash surrender values on corporate-owned life insurance policies and other expenses of the SERP, $0.2 million increase in public company costs and $0.5 million increase in costs associated with store closures and asset impairment costs. These increases were partially offset by a $0.6 million decrease in share-based compensation expense associated with our equity compensation program and a $0.8 million decrease in other expenses.

As a percentage of sales, operating and administrative expenses for the sixteen weeks ended October 7, 2018 increased 0.6% to 14.0% as compared to 13.4% for the sixteen weeks ended October 8, 2017. Operating and administrative expenses, as a percentage of sales, increased by 0.43% due to increased wages, benefits and incentive bonuses (including a 0.37% increase related to our *Smart & Final* segment and 0.06% increase related to our *Smart Foodservice* segment), 0.22% increase due to other store direct expenses (primarily related to our *Smart & Final* segment), 0.03% increase in costs related to store closures and asset impairment costs, 0.06% increase in expense associated with cash surrender values on corporate-owned life insurance policies and other expenses of the SERP, and 0.01% increase in public company costs. These increases were offset by a 0.05% decrease in share-based compensation expense associated with our equity compensation program and a 0.07% decrease in other expenses.

Interest Expense, Net

Interest expense for the sixteen weeks ended October 7, 2018 increased $2.0 million, or 18.0%, to $13.3 million as compared to $11.2 million for the sixteen weeks ended October 8, 2017. This increase in interest expense was primarily due to increased average debt outstanding and a slight increase in interest rate.

Income Tax Provision

Our income tax provision for the sixteen weeks ended October 7, 2018 decreased $2.8 million to a $0.2 million income tax benefit as compared to a $2.6 million income tax provision for the sixteen weeks ended October 8, 2017. The effective income tax rate, excluding the equity in earnings of our joint venture, for the sixteen weeks ended October 7, 2018 was an income tax benefit of 2.2% as compared to an income tax provision of 35.5% for the sixteen weeks ended October 8, 2017. The effective tax rate for the sixteen weeks ended October 7, 2018 was lower primarily due to the federal income tax rate cut from 35% to 21% and the favorable adjustment resulting from the reconciliation of our 2017 tax return as filed to our 2017 tax provision, partially offset by the unfavorable impact of the new executive compensation limitations and vesting of restricted stock awards as compared to the sixteen weeks ended October 8, 2017.

Equity in Earnings of Joint Venture

Equity in earnings of our joint venture for the sixteen weeks ended October 7, 2018 was $0.7 million as compared to $0.4 million for the sixteen weeks ended October 8, 2017.

Forty Weeks Ended October 7, 2018 Compared to the Forty Weeks Ended October 8, 2017

Net Sales

Net sales for the forty weeks ended October 7, 2018 increased $136.7 million, or 3.9%, to $3,639.4 million as compared to $3,502.7 million for the forty weeks ended October 8, 2017. This increase in net sales was primarily attributable to net sales of $101.8 million from the opening of eleven new stores since third quarter 2017 and a comparable store sales increase of $34.9 million in our store banners.

Comparable store sales for the forty weeks ended October 7, 2018 increased 1.0% as compared to the forty weeks ended October 8, 2017. This increase in comparable store sales was primarily attributable to an increase in comparable average transaction size of 2.4% partially offset by a decrease in comparable transaction count of 1.4%.

For the forty weeks ended October 7, 2018, net sales for our *Smart & Final* segment increased $91.4 million, or 3.4%, to $2,807.7 million as compared to $2,716.4 million for the forty weeks ended October 8, 2017. Comparable store sales for our *Smart & Final* segment increased 0.3% as compared to the forty weeks ended October 8, 2017, primarily attributable to an increase in comparable average transaction size of 1.9%, partially offset by a decrease in comparable transaction count of 1.6%.

For the forty weeks ended October 7, 2018, net sales for our *Smart Foodservice* segment increased $45.3 million, or 5.8%, to $831.7 million as compared to $786.3 million for the forty weeks ended October 8, 2017. Comparable store sales for our *Smart Foodservice* segment increased 3.4% as compared to the forty weeks ended October 8, 2017, primarily attributable to an increase in comparable average transaction size of 3.4%, while comparable transaction count remained the same.

As a result of our store growth in existing markets, we also have experienced sales transfer from certain existing stores to new stores. In comparable store sales, we believe that the principal effect of this sales transfer is evidenced in the comparable sales transaction count.

Gross Margin

Gross margin for the forty weeks ended October 7, 2018 increased $39.2 million, or 7.7%, to $548.4 million as compared to $509.2 million for the forty weeks ended October 8, 2017. The increase in gross margin attributable to increased sales was $19.9 million, and the other $19.3 million increase was primarily attributable to increased gross margin rate. As a percentage of sales, gross margin was 15.1% for the forty weeks ended October 7, 2018 compared to 14.5% for the forty weeks ended October 8, 2017. Compared to the forty weeks ended October 8, 2017, gross margin as a percentage of sales for the forty weeks ended October 7, 2018 included higher merchandise product margin rates (including the effect of inventory losses) as a percentage of sales accounting for an increase of 0.63% (including an increase of 0.44% related to our *Smart & Final* segment and 0.19% increase related to our *Smart Foodservice* segment). Warehouse and transportation costs as a percentage of sales increased 0.07% (representing a 0.05% increase related to our *Smart & Final* segment, and a 0.02% increase related to our *Smart Foodservice* segment). Store occupancy costs as a percentage of sales increased 0.04% (consisting of an increase of 0.02% related to our *Smart & Final* segment and a 0.02% increase related to our *Smart Foodservice* segment). This increase in our *Smart & Final* segment included an increase of 0.11% related to stores opened in 2015 through third quarter 2017, partially offset by a 0.09% decrease related to store locations opened prior to 2015.

Operating and Administrative Expenses

Operating and administrative expenses for the forty weeks ended October 7, 2018 increased $33.9 million, or 7.1%, to $507.9 million, as compared to $474.0 million for the forty weeks ended October 8, 2017. The increase in operating and administrative expenses was primarily due to a $20.1 million increase in wages, fringe benefits and incentive bonus costs, $6.7 million increase in other store direct expenses, $1.6 million increase in share-based compensation expense associated with our equity compensation program, $0.5 million increase in marketing costs, $1.7 million increase in costs associated with store closure and asset impairment costs, $1.1 million increase in expense associated with cash surrender values on corporate-owned life insurance policies and other expenses of the SERP, and $2.3 million increase in other expenses mainly due to higher information technology consulting fees.

As a percentage of sales, operating and administrative expenses for the forty weeks ended October 7, 2018 increased 0.5% to 14.0% as compared to 13.5% for the forty weeks ended October 8, 2017. Operating and administrative expenses as a percentage of sales, increased by 0.24% due to increased wages, benefits and incentive bonuses (including 0.17% increase related to our *Smart & Final* segment and 0.07% increase related to our *Smart Foodservices* segment), 0.03% due to increased share-based compensation expense associated with our equity compensation program, 0.07% due to an increase in other store direct expenses (primarily related to our *Smart & Final* segment), 0.04% increase in costs related to store closures and asset impairment costs, 0.03% due to expense associated with cash surrender values on corporate-owned life insurance policies and other expenses of the SERP, and 0.03% due to increased other expenses primarily due to higher information technology consulting fees. These increases were offset by a 0.02% decrease in marketing costs.

Interest Expense, Net

Interest expense for the forty weeks ended October 7, 2018 increased $4.4 million, or 16.0%, to $32.2 million as compared to $27.7 million for the forty weeks ended October 8, 2017. This increase in interest expense was primarily due to both increased average debt outstanding and interest rate.

Income Tax Provision

Our income tax provision for the forty weeks ended October 7, 2018 decreased $0.1 million to a provision of $0.3 million as compared to a $0.4 million provision for the forty weeks ended October 8, 2017. The effective income tax rate, excluding the equity in earnings of our joint venture, for the forty weeks ended October 7, 2018 was a provision of 3.1% as compared to a provision of 5.6% for the forty weeks ended October 8, 2017. The effective tax rate for the forty weeks ended October 7, 2018 was primarily due to the favorable impact of the federal income tax rate cut from 35% to 21%, the adjustment resulting from the reconciliation of our 2017 tax return as filed to our 2017 tax provision and certain tax credits, partially offset by the unfavorable impact of the new executive compensation limitations, state income tax expense and the vesting of restricted stock awards. The effective tax rate for the forty weeks ended October 8, 2017 was primarily impacted by favorable excess tax benefits from stock option award exercises and restricted stock vesting, partially offset by the unfavorable impact of executive compensation limitations and state income tax expense.

Equity in Earnings of Joint Venture

Equity in earnings of our joint venture for the forty weeks ended October 7, 2018 was $1.6 million as compared to $0.6 million for the forty weeks ended October 8, 2017.

Liquidity and Capital Resources

Historically, our primary source of liquidity has been cash flows from operations. Additionally, we have the availability to make borrowings under our Credit Facilities. Our primary uses of cash are for purchases of inventory, operating expenses, capital expenditures primarily for opening, converting or remodeling stores and debt service. As of October 7, 2018, we had $35.0 million drawn under our Revolving Credit Facility and $62.2 million of cash and cash equivalents.

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

(dollars in thousands)	Forty Weeks Ended October 7, 2018	Forty Weeks Ended October 8, 2017
Cash and cash equivalents at end of period	$ 62,174	$ 60,890
Cash provided by operating activities	109,457	128,040
Cash used in investing activities	(107,935)	(116,312)
Cash used in financing activities	(11,019)	(5,073)

Operating Activities

Cash flows from operating activities consist of net income adjusted for non-cash items including depreciation and amortization, and share-based compensation and the effect of working capital changes. The increase or decrease in cash provided by operating activities for the forty weeks ended October 7, 2018 and October 8, 2017 reflects our operating performance before non-cash expenses and charges and including the timing of receipts and disbursements.

Cash provided by operating activities for the forty weeks ended October 7, 2018 decreased $18.6 million to $109.5 million as compared to $128.0 million for the forty weeks ended October 8, 2017. This decrease was primarily attributable to higher working capital. During the forty weeks ended October 7, 2018, we made cash interest payments of $29.2 million and cash pension contributions of $8.9 million, as compared to cash interest payments of $26.2 million and cash pension contributions of $9.7 million during the forty weeks ended October 8, 2017.

Investing Activities

Cash used in investing activities decreased $8.4 million to $107.9 million for the forty weeks ended October 7, 2018 as compared to $116.3 million in the forty weeks ended October 8, 2017. This decrease was primarily attributable to a $11.2 million decrease in capital expenditures for property, plant and equipment, a $1.8 million decrease in proceeds on sale of assets and a $0.3 million decrease in other, partially offset by a $1.3 million increase in capital expenditures for capitalized software.

Financing Activities

Cash used in financing activities increased $5.9 million to $11.0 million for the forty weeks ended October 7, 2018, as compared to cash used of $5.1 million for the forty weeks ended October 8, 2017. This increase was primarily attributable to $52.0 million reduction in net borrowings on our Revolving Credit Facility, a $1.9 million decrease in proceeds from exercise of stock options, and a $1.8 million reduction in borrowings associated with a promissory note, partially offset by a $35.7 million increase in cash from landlord related to financing lease obligations, a $12.9 million decrease in cash used for repurchases of Common Stock, and a $1.2 million reduction in payment of minimum withholding taxes on net share settlement of stock option exercises.

At October 7, 2018, we had cash and cash equivalents of $62.2 million, stockholders' equity of $423.5 million and debt, less debt issuance costs, of $653.0 million. At October 7, 2018, we had working capital of $18.4 million as compared to $35.6 million of negative working capital at October 8, 2017, primarily due to reduction of Revolving Credit Facility.

Contractual Obligations

The following table sets forth our future payments due by period of our contractual obligations as of October 7, 2018, in thousands:

	Total	Less than one year	1 - 3 Years	3 - 5 Years	Thereafter
Long-term debt	$ 660,000	$ 35,000	$ —	$ 625,000	$ —
Interest on long-term debt	168,985	39,236	84,322	45,427	—
Operating leases	1,469,354	139,629	270,448	225,395	833,882
Capital and financing lease obligations	56,881	3,189	6,378	6,622	40,692
Total contractual obligations	$ 2,355,220	$ 217,054	$ 361,148	$ 902,444	$ 874,574

The primary changes in our contractual obligations as of October 7, 2018 as compared to our contractual obligations as of December 31, 2017 relate to additional leases entered into primarily related to our new store growth, partially offset by payments made in the forty weeks ended October 7, 2018.

Smart & Final's interest rate swap expired March 29, 2018 without a new interest rate swap being initiated. See Note 4, Debt, to our unaudited condensed consolidated financial statements for additional information on our interest requirements.

Purchase orders or contracts for the purchase of goods for resale in our stores and other goods and services are not included in the table above. We are not able to reasonably determine the aggregate amount of such purchase orders that may constitute established contractual obligations, as purchase orders may represent individual authorizations to purchase rather than binding agreements. Other than with respect to Unified Grocers (as described immediately below), we do not have significant agreements for the purchase of goods for resale in our stores or other goods and services that exceed our expected requirements or that are not cancelable on short notice.

We have a contractual obligation under our supply agreement with Unified Grocers to purchase a minimum amount of food and related items during any twelve-month period covered by the agreement. This contractual obligation does not exceed our expected requirements over any twelve-month period covered by the agreement. This agreement expires in December 2018. The related amounts are not included in the above table.

The table above also excludes funding of pension and other postretirement benefit and postemployment obligations. See Note 6, Retirement Benefit Plans and Postretirement and Postemployment Benefit Obligations, to our unaudited condensed consolidated financial statements for additional information on funding of our plans.

We also have asset retirement obligations with respect to owned or leased properties. Due to the nature of our business, such asset retirement obligation is immaterial.

Off-Balance Sheet Arrangements

As of October 7, 2018, we had no off-balance sheet arrangements.

Critical Accounting Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States (''U.S. GAAP'') requires management to make estimates and assumptions that affect the reported assets, liabilities, sales and expenses in the accompanying financial statements. Critical accounting estimates are those that require the most subjective and complex judgments, often employing the use of estimates about the effect of matters that are inherently uncertain. These critical accounting estimates, under different conditions or using different assumptions or estimates, could show materially different results on our financial condition and results of operations. The following are considered our most critical accounting estimates that, under different conditions or using different assumptions or estimates, could show materially different results on our financial condition and results of operations.

Share-Based Compensation

We account for share-based compensation in accordance with ASC 718, *Compensation—Stock Compensation* ("ASC 718"). ASC 718 requires all share-based payments to be recognized in the condensed consolidated statements of operations and comprehensive income as compensation expense based on their fair values over the requisite service period of the award, taking into consideration estimated forfeiture rates.

We use the Black-Scholes-Merton option-pricing model to estimate the fair value of the options on the date of each grant. The Black-Scholes-Merton option-pricing model utilizes highly subjective and complex assumptions to determine the fair value of share-based compensation, including the option's expected term and price volatility of the underlying stock. The methods used to develop our assumptions are discussed further in Note 8, Share-Based Compensation, in the accompanying notes to our audited consolidated financial statements.

In addition to assumptions used in the Black-Scholes-Merton option pricing model, we must also estimate a forfeiture rate to calculate the share-based compensation cost for our awards. Our forfeiture rate is based on an analysis of our actual historical forfeitures and consideration of future expected forfeiture rates.

The assumptions referred to above represent management's best estimates. These estimates involve inherent uncertainties and the application of management's judgment. If these assumptions change and different factors are used, our share-based compensation expense could be materially different in the future. We do not believe there is a reasonable likelihood that changes in the assumptions used in our estimates will have a material effect on our financial condition or results of operations in future periods. Changes in future share-based compensation expense related to these awards may result from changes in forfeiture rates. However, we do not believe there is a reasonable likelihood that such changes will be material.

We recognize compensation cost for graded vesting awards as if they were granted in multiple awards. We believe the use of this "multiple award" method is preferable because a stock option grant or a restricted stock grant with graded vesting is effectively a series of individual grants that vests over various periods. Management also believes that this provides for better matching of compensation costs with the associated services rendered throughout the applicable vesting periods.

Inventories

Inventories consist of merchandise purchased for resale which is stated at the lower of the weighted-average cost (which approximates first-in, first-out ("FIFO")) or net realizable value. We provide for estimated inventory losses between physical inventory counts at our stores based upon historical inventory losses as a percentage of sales. Physical inventory counts are conducted on a recurring and frequent basis throughout the year. The provision for inventory loss is adjusted periodically to reflect updated trends of actual physical inventory count results. Historically, our actual physical inventory count results have shown our estimates to be materially reliable. We do not believe there is a reasonable likelihood that changes in our estimates will have a material effect on our financial condition or results of operations in future periods.

The proper valuation of inventory also requires us to estimate the net realizable value of our slow-moving inventory at the end of each period. We base net realizable values upon many factors, including historical recovery rates, the aging of inventories on hand, the inventory movement of specific products and the current economic conditions. When we have determined inventory to be slow-moving, the inventory is reduced to its net realizable value by recording an obsolescence valuation allowance. We believe these risks are largely mitigated because our inventory typically turns on average in less than three months.

With regard to the proper valuation of inventories, we review our valuation methodologies on a recurring basis and make refinements where the facts and circumstances dictate.

Goodwill and Intangible Assets

We account for goodwill and identified intangible assets in accordance with ASC 350, *Intangibles—Goodwill and Other*. Goodwill and identifiable intangible assets with indefinite lives are not amortized, but instead are evaluated on an annual basis for impairment, or more frequently if events or changes in circumstances indicate that the asset might be impaired.

We evaluate goodwill for impairment by comparing the fair value of each reporting unit to its carrying value including the associated goodwill. We have designated our reporting units to be our *Smart & Final* banner and our *Smart Foodservice* banner. We determine the fair value of the reporting units using a combination of the income approach methodology of valuation that utilizes the discounted cash flow method as well as other generally accepted valuation methodologies including the market comparable and market transaction methods.

Determining market values using a discounted cash flow method requires that we make significant estimates and assumptions, including long-term projections of cash flows, market conditions and appropriate market rates. Our judgments are based on historical experience, current market trends and other information. In estimating future cash flows, we rely on internally generated forecasts for operating profits and cash flows, including capital expenditures. Critical assumptions include projected comparable store sales growth, timing and number of new store openings, operating profit rates, general and administrative expenses, direct store expenses, capital expenditures, discount rates, royalty rates and terminal growth rates. We determine discount rates based on the weighted average cost of capital of a market participant. Such estimates are derived from our analysis of peer companies and consider the industry weighted average return on debt and equity from a market participant perspective. We also use comparable market earnings multiple data and market transaction data in determining market values. Factors that could cause us to change our estimates of future cash flows include a prolonged economic crisis, successful efforts by our competitors to gain market share in our core markets, our inability to compete effectively with other retailers or our inability to maintain price competitiveness. We also evaluate the market capitalization of the Company in corroborating the reasonableness of the underlying reporting unit valuations. In the fourth quarter of fiscal year 2017, we completed our quantitative assessment of potential goodwill impairment and concluded that the fair value of the *Smart Foodservice* reporting unit exceeded its carrying value, by over 109%. Based on this excess of fair value over carrying value, we believe that reasonable variations in the estimates and assumptions used in our impairment analysis for the *Smart Foodservice* reporting unit would not result in an indication that the reporting unit's goodwill may be impaired. In the fourth quarter of fiscal year 2017, we also completed our quantitative assessment of potential goodwill impairment associated with the *Smart & Final* reporting unit and concluded that the fair value fell short of its carrying value, resulting in a goodwill impairment charge of $180.0 million. This is discussed further in Note 2, Significant Accounting Policies—Goodwill and Intangible Assets in the accompanying notes to our audited consolidated financial statements. If certain future events occur, such as changes to the Company's long-term store growth and development plans, changes in the assumptions used to estimate the fair value of the *Smart & Final* banner reporting unit or a prolonged depression of the Company's market capitalization, the *Smart & Final* banner reporting unit's goodwill may require a subsequent impairment charge to be taken.

We evaluate our indefinite-lived intangible assets associated with trade names using a two-step approach. The first step screens for potential impairment by comparing the fair value of each trade name with its carrying value. The second step measures the amount of impairment. We determine the fair value of the indefinite-lived trade names using a "relief from royalty payments" methodology. This methodology involves estimating reasonable royalty rates for each trade name and applying these royalty rates to a revenue stream and discounting the resulting cash flows to determine fair value. In the periods presented, we did not recognize any indefinite-lived trade name impairment loss as a result of such evaluation.

Finite-lived intangible assets, like other long-lived assets as required by ASC 360 (as defined below), are subject to review for impairment whenever events or changes in circumstances indicate that the carrying amount of the finite-lived intangible asset may not be recoverable. Impairment is recognized to the extent the sum of the discounted estimated future cash flows from the use of the finite-lived intangible asset is less than the carrying value.

Impairments of Long-Lived Assets

In accordance with ASC 360, *Property, Plant, and Equipment*, ("ASC 360"), we assess our long-lived assets, including property, plant and equipment and assets under capital leases, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. We believe that impairment assessment of long-lived assets is critical to the financial statements because the recoverability of the amounts, or lack thereof, could significantly affect our results of operations. Determining whether an impairment has occurred typically requires various estimates and assumptions, including determining which cash flows are directly related to the potentially impaired asset, the useful life over which cash flows will occur, amount of such cash flows, and the asset's residual value, if any. In turn, measurement of an impairment loss requires a determination of fair value, which is based on the best information available. We use internal discounted cash flow estimates and independent appraisals as appropriate to determine fair value. We derive the required cash flow estimates from our historical experience and our internal business plans and apply an appropriate discount rate. We group and evaluate long-lived assets for impairment at the individual store level, which is the lowest level at which individual identifiable cash flows are available. We regularly review our stores' operating performance for indicators of impairment, which include a significant underperformance relative to expected historical or projected future results of operations or a significant negative industry or economic trend.

Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its future undiscounted cash flows, an impairment charge is recognized equal to the excess of the carrying value over the estimated fair value of the asset. We measure the fair value of our long-lived assets on a nonrecurring basis using Level 3 inputs as defined in the fair value hierarchy.

Capitalized software costs are subject to review for impairment whenever events or changes in circumstances indicate that the carrying amount of the capitalized software may not be recoverable, whether it is in use or under development. Impairment is recognized to the extent the sum of the future discounted cash flows from the use of the capitalized software is less than the carrying value.

Application of alternative assumptions, such as changes in estimates of future cash flows, could produce significantly different results. Because of the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if we used different assumptions or if the underlying circumstances were to change.

Income Taxes

Our income tax expense, deferred tax assets and liabilities, and liabilities for unrecognized tax benefits reflect management's best estimate of current and future taxes to be paid. We are subject to income taxes in the United States and Mexico.

Income taxes are accounted for under the balance sheet model for recording current and deferred taxes. Deferred tax assets and liabilities are measured using currently enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities for a change in tax rates is recognized in income in the period that includes the enactment date. Under applicable accounting guidance, we are required to evaluate the realizability of our deferred tax assets. The realization of our deferred tax assets is dependent upon all available evidence, both positive and negative, including reversals of deferred tax liabilities, projected future taxable income, tax-planning strategies and results of recent operations. The assumptions about future taxable income require the use of significant judgment and are consistent with the plans and estimates we are using to manage our underlying businesses. We consider objective historical evidence when evaluating future taxable income, including three years of cumulative operating income (loss). Applicable accounting guidance requires that we recognize a valuation allowance when it is more likely than not that all or a portion of a deferred tax asset will not be realized due to the inability to generate sufficient taxable income in future periods. Accordingly, significant accounting judgment is required in our assessment of deferred tax assets and valuation allowances when determining the provision for income taxes and related accruals.

The calculation of our tax liabilities involves uncertainties in the application of complex tax laws and regulations in different jurisdictions. A tax benefit from an uncertain tax position may be recognized when it is more likely than not that the position will be sustained upon examination, which includes resolution of any related appeals or litigation processes, on the basis of the technical merits.

We record unrecognized tax benefits as liabilities and adjust these liabilities when our judgment changes as a result of the evaluation of new information not previously available. Because of the complexity of some of these uncertainties, the ultimate resolution may result in a payment that is materially different from our estimates of unrecognized tax benefit liabilities. These differences will be reflected as increases or decreases to income tax expense in the period in which new information is available.

Self-Insurance

We have various insurance programs related to our risks and costs associated with workers' compensation and general liability claims. We have elected to purchase third-party insurance to cover the risk in excess of certain dollar limits established for each respective insurance program.

We are also responsible for the payment of claims less than the insured amount. We establish estimated accruals for our insurance programs based on certain factors, including available claims data, historical trends and experience, as well as projected ultimate costs of the claims. These accruals are based on estimates prepared with the assistance of outside actuaries, and the ultimate cost of these claims may vary from initial estimates and established accruals. We believe that the use of actuarial studies to determine self-insurance accruals represents a consistent method of measuring these subjective estimates. The actuaries periodically update their estimates and we record such adjustments in the period in which such determination is made. The inherent uncertainty of future loss projections could cause actual claims to differ from our estimates. Because of the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if we used different assumptions or if the underlying circumstances were to change. For example, a 5% change in our insurance and self-insured claims liabilities at December 31, 2017, excluding the risk in excess of certain dollar limits related to self-insured program with our third-party insurance carriers, would have affected pre-tax income by approximately $2.3 million for fiscal year 2017. Historically, periodic adjustments to our estimates have not been material.

Closed Store Reserve

We maintain reserves for costs associated with closures of operating stores and other properties that are no longer being utilized in current operations. In the event a leased store is closed before the expiration of the associated lease, the discounted remaining lease obligation less estimated sublease rental income, asset impairment charges related to improvements and fixtures, inventory write-downs and other miscellaneous closing costs associated with the disposal activity are recognized when the store closes.

Adjustments to closed stores and other properties reserves primarily relate to changes in estimated timing and amounts of subtenant income or actual exit costs differing from original estimates. Adjustments are made for changes in estimates in the period in which the changes become known. Because of the significance of the judgments and estimation processes, it is likely that materially different amounts could be recorded if we used different assumptions or if the underlying circumstances were to change. For example, a 5% change in our closed stores and other properties reserves at December 31, 2017, would have affected pre-tax income by approximately $0.4 million for fiscal year 2017.

Retirement Benefit Plans and Postretirement Benefit Plans

Certain of our employees are covered by a funded noncontributory qualified defined benefit pension plan. U.S. GAAP requires that we measure the benefit obligations and fair value of plan assets that determine our plans' funded status as of our fiscal year end date.

The determination of our obligation and expense for retirement benefit plans and postretirement benefit plans is dependent, in part, on our selection of certain assumptions used by us and our actuaries in calculating such amounts. Those assumptions are described in Note 7, Retirement Benefit Plans and Postretirement and Postemployment Benefit Obligations, in our Annual Report on Form 10-K filed with the SEC on March 16, 2018. Pension assumptions are significant inputs to the actuarial models that measure pension benefit obligations and related effects on operations. Three assumptions, among others—discount rate, expected long-term return on plan assets and rate of compensation increases—are important elements of plan expense and asset/liability measurement. We evaluate these critical assumptions at least annually. We periodically evaluate other assumptions involving demographic factors, such as retirement age, mortality and turnover, and update them to reflect our experience and expectations for the future. In 2017, the Society of Actuaries released revised mortality scales, which update life expectancy assumptions. In consideration of these scales, we modified the mortality assumptions used in determining our retirement benefit plans and postretirement benefit plans as of December 31, 2017. The impact of these updated mortality assumptions resulted in a slight decrease to our pension, supplemental executive retirement plan ("SERP") and postretirement benefit plan obligations and a slight decrease in future related expense. Actual results in any given year will often differ from actuarial assumptions because of economic and other factors.

In accordance with U.S. GAAP, the amount by which actual results differ from the actuarial assumptions is accumulated and amortized over future periods and, therefore, affects recognized expense in such future periods. While we believe our assumptions are appropriate, significant differences in actual results or significant changes in our assumptions may materially affect our pension and other postretirement obligations and future expenses.

We determine the discount rate using current investment yields on high quality fixed-income investments. The discount rate assumption used to determine the year-end projected benefit obligation is increased or decreased to be consistent with the change in yield rates for high quality fixed-income investments for the expected period to maturity of the pension benefits. A lower discount rate increases the present value of benefit obligations and increases pension expense. The discount rate used to determine benefit obligations for our defined benefit pension plan as of December 31, 2017 was 3.75%. The discount rate used to determine benefit obligations under our SERP as of December 31, 2017 was 3.19%. The discount rate used to determine benefit obligations under our postretirement benefit plan as of December 31, 2017 was 3.70%.

We determine the expected long-term rate of return on plan assets for our defined benefit pension plan using an allocation approach that considers diversification and rebalancing for a portfolio of assets invested over a long-term time horizon. The approach relies on the historical returns of the plan's portfolio as well as relationships between equities and fixed income investments, consistent with the widely accepted capital market principle that a diversified portfolio with a larger allocation to equity investments have historically generated a greater long term return. For fiscal year 2017, the Company's assumed rate of return for our defined benefit pension plan was 6.75%.

Sensitivity to changes in the major assumptions for our benefit plans are as follows (dollars in thousands):

Assumption	Change	Projected benefit obligation (decrease)increase	Expense (decrease) increase
Defined benefit pension plan:			
Discount rate	+/– 50 bps	$(20,886)/$23,799	$(40)/$414
Expected long-term return on plan assets	+/– 50 bps	—	(858)858
SERP:			
Discount rate	+/– 50 bps	(1,316)/1,416	108/547
Postretirement benefit plan:			
Discount rate	+/– 50 bps	(1,119)/1,251	(7)/6

Vendor Rebates and Other Allowances

As a component of our consolidated procurement program and consistent with standard practices in the retail industry, we frequently enter into contracts with vendors that provide for payments of rebates or other allowances. These rebates and allowances are primarily comprised of volume or purchase-based incentives, advertising allowances and promotional discounts. The purpose of these incentives and allowances is generally to help defray the costs we incur for stocking, advertising, promoting and selling the vendor's products.

As prescribed by U.S. GAAP, these vendor payments are reflected in the carrying value of the inventory when earned or as progress is made toward earning the rebate or allowance and as a component of cost of sales as the inventory is sold. Certain of these vendor contracts provide for rebates and other allowances that are contingent upon us meeting specified performance measures such as a cumulative level of purchases over a specified period of time. Such contingent rebates and other allowances are given accounting recognition at the point at which achievement of the specified performance measures are deemed to be probable and reasonably estimable. We review the relevant or significant factors affecting proper performance measures, rebates and other allowances on a recurring basis and make adjustments where the facts and circumstances dictate. We do not believe there is a reasonable likelihood that changes in the assumptions used in our estimate will have a material effect on our financial condition or results of our operations in future periods.

Recently Issued Accounting Pronouncements

See Note 3, Recent Accounting Pronouncements, to our accompanying unaudited condensed consolidated financial statements contained elsewhere in this Quarterly Report on Form 10-Q. We have determined that all other recently issued accounting standards will not have a material impact on our consolidated financial statements, or do not apply to our operations.

Item 3. Quantitative and Qualitative Disclosures about Market Risk.

Market risk represents the risk of changes in the value of market risk sensitive instruments caused by fluctuations in interest rates, foreign exchange rates and commodity prices. Changes in these factors could cause fluctuations in the results of our operations and cash flows. In the ordinary course of business, we are primarily exposed to foreign currency and interest rate risks. We do not use derivative financial instruments in connection with these commodity market risks.

Commodity Risk

We are subject to volatility in food costs as a result of market risk associated with commodity prices. Although we typically are able to mitigate these cost increases, our ability to continue to do so, either in whole or in part, may be limited by the competitive environment we operate in.

Interest Rate Market Risk

Based on our variable rate debt balance as of October 7, 2018, a 1% increase in interest rates would increase our annual interest cost by approximately $6.3 million. A decrease of 1% in interest rates would decrease our annual interest cost by $6.3 million regardless of the interest rate floor that exists on the Term Loan Facility. As our interest rate hedge expired on March 29, 2018, there are no hedges in place that would impact or offset the interest expense due to rate sensitivity.

Foreign Currency Exchange Rate Market Risk

We are exposed to market risks relating to fluctuations in foreign exchange rates between the U.S. dollar and other foreign currencies, primarily the Mexican Peso. Our exposure to foreign currency risk is limited to our operations in Mexico and the equity earnings of our joint venture. Such exposure, as of October 7, 2018, is primarily related to our $16.7 million equity investment in the Mexico joint venture. The remainder of our business is conducted in U.S. dollars and thus is not exposed to fluctuation in foreign currency. We do not hedge our foreign currency exposure and therefore are not exposed to such hedging risk.

Item 4. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), has evaluated the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a- 15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) as of the end of the period covered by this report. Disclosure controls and procedures are designed to provide reasonable assurance that the information required to be disclosed in the reports that we file or submit under the Exchange Act has been appropriately recorded, processed, summarized and reported on a timely basis and are effective in ensuring that such information is accumulated and communicated to the Company’s management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure. Based on such evaluation, our CEO and CFO have concluded that, as of October 7, 2018, our disclosure controls and procedures are effective.

Changes in Internal Control Over Financial Reporting

During our quarter ended October 7, 2018, we implemented an enterprise resource planning (ERP) software program, SAP, to replace our prior ERP system. In conjunction with the implementation of SAP, we modified the design, operation and documentation of certain internal controls over financial reporting. There have been no other changes in our internal control over financial reporting (as defined in Rules 13a-15(f) under the Exchange Act) during the period covered by this Quarterly Report on Form 10-Q that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II - OTHER INFORMATION

Item 1. Legal Proceedings.

We are engaged in various legal actions, claims and proceedings in the ordinary course of business, including claims related to employment related matters, breach of contracts, products liabilities and intellectual property matters resulting from our business activities. We do not believe that the ultimate resolution of these pending claims will have a material adverse effect on our business, financial condition, results of operations or cash flows. However, litigation is subject to many uncertainties, and the outcome of certain individual litigated matters may not be reasonably predictable and any related damages may not be estimable. Some litigation matters could result in an adverse outcome to us, and any such adverse outcome could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Item 1A. Risk Factors.

For a discussion of our potential risks and uncertainties, see the information in Part I, Item 1A. "Risk Factors" in our Annual Report on Form 10-K, for the year ended December 31, 2017 filed with the SEC on March 16, 2018. There have been no material changes to the risk factors disclosed in our Annual Report on Form 10-K.

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

None.

Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 5. Other Information.

None.

Item 6. Exhibits.

Exhibit No.	Description
3.1	Second Amended and Restated Certificate of Incorporation of Smart & Final Stores, Inc. (1)
3.2	Second Amended and Restated Bylaws of Smart & Final Stores, Inc. (1)
31.1	Certification of Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
31.2	Certification of Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.*
32.1	Certification of CEO and CFO Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.*
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema Document*
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*
101.LAB	XBRL Taxonomy Extension Label Linkbase Document*
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document*

* Filed herewith

(1) Filed as an exhibit to Amendment No. 5 to the Registrant's Registration Statement on Form S-1 (File No. 333-196931) filed with the SEC on September 22, 2014, and incorporated herein by reference.

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SIGNATURES

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

SMART & FINAL STORES, INC.
(Registrant)

November 14, 2018

/s/ DAVID G. HIRZ
David G. Hirz
Chief Executive Officer
(Principal Executive Officer)

November 14, 2018

/s/ RICHARD N. PHEGLEY
Richard N. Phegley
Chief Financial Officer
(Principal Financial Officer)

Exhibit 31.1

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

I, David G. Hirz, certify that:

1. I have reviewed this Form 10-Q of Smart & Final Stores, Inc.;

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

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

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

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

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

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

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

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

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

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

Date: November 14, 2018

/s/ DAVID G. HIRZ
David G. Hirz
Chief Executive Officer
(Principal Executive Officer)

Exhibit 31.2

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

I, Richard N. Phegley, certify that:

1. I have reviewed this Form 10-Q of Smart & Final Stores, Inc.;

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

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

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

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

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

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

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

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

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

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

November 14, 2018

/s/ RICHARD N. PHEGLEY
Richard N. Phegley
Chief Financial Officer
(Principal Financial Officer)

Exhibit 32.1

Certification of CEO and CFO Pursuant to
18 U.S.C. Section 1350,
as Adopted Pursuant to
Section 906 of the Sarbanes-Oxley Act of 2002

In connection with the Quarterly Report on Form 10-Q of Smart & Final Stores, Inc. (the "Company"), for the quarterly period ended October 7, 2018 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), David G. Hirz, as Chief Executive Officer of the Company, and Richard N. Phegley, as Chief Financial Officer of the Company, each hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to the best of his knowledge:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

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

/s/ DAVID G. HIRZ
Name: David G. Hirz
Title: Chief Executive Officer
(Principal Executive Officer)
Date: November 14, 2018

/s/ RICHARD N. PHEGLEY
Name: Richard N. Phegley
Title: Chief Financial Officer
(Principal Financial Officer)
Date: November 14, 2018

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to the Company and will be retained by the Company and furnished to the SEC or its staff upon request.

Document Format Files

Seq	Description	Document	Type	Size
1	10-Q	a18-19013_110q.htm	10-Q	1192398
2	EX-31.1	a18-19013_1ex31d1.htm	EX-31.1	13451
3	EX-31.2	a18-19013_1ex31d2.htm	EX-31.2	12524
4	EX-32.1	a18-19013_1ex32d1.htm	EX-32.1	11490
	Complete submission text file	0001104659-18-068607.txt		7621222

Data Files

Seq	Description	Document	Type	Size
5	XBRL INSTANCE DOCUMENT	sfs-20181007.xml	EX-101.INS	2149075
6	XBRL TAXONOMY EXTENSION SCHEMA DOCUMENT	sfs-20181007.xsd	EX-101.SCH	37226
7	XBRL TAXONOMY EXTENSION CALCULATION LINKBASE DOCUMENT	sfs-20181007_cal.xml	EX-101.CAL	55059
8	XBRL TAXONOMY EXTENSION	sfs-	EX-	183772

8	DEFINITION LINKBASE DOCUMENT	20181007_def.xml	101.DEF	183772
9	XBRL TAXONOMY EXTENSION LABELS LINKBASE DOCUMENT	sfs-20181007_lab.xml	EX-101.LAB	454133
10	XBRL TAXONOMY EXTENSION PRESENTATION LINKBASE DOCUMENT	sfs-20181007_pre.xml	EX-101.PRE	353629