INGLES MARKETS INC
Form 10-Q
May 03, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 25, 2017

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 0-14706.

INGLES MARKETS, INCORPORATED

(Exact name of registrant as specified in its charter)

North Carolina (State or other jurisdiction of incorporation or organization)	56-0846267 (I.R.S. Employer Identification No.)
P.O. Box 6676, Asheville NC (Address of principal executive offices)	28816 (Zip Code)

(828) 669-2941

Registrant's telephone number, including area code

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

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

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

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

Emerging growth company

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

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

As of May 1, 2017 the Registrant had 14,071,794 shares of Class A Common Stock, $0.05 par value per share, outstanding and 6,187,982 shares of Class B Common Stock, $0.05 par value per share, outstanding.

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INGLES MARKETS, INCORPORATED

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Part I. FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

	March 25, 2017	September 24, 2016
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 6,104,260	$ 5,679,509
Receivables - net	63,544,007	61,735,387
Inventories	348,067,707	343,881,078
Other current assets	12,733,545	7,191,465
Total Current Assets	430,449,519	418,487,439
Property and Equipment - Net	1,251,373,614	1,247,881,773
Other Assets	21,369,878	20,109,087
Total Assets	$ 1,703,193,011	$ 1,686,478,299
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Current portion of long-term debt	$ 10,061,559	$ 10,000,629
Accounts payable - trade	165,344,222	155,288,402
Accrued expenses and current portion of other long-term liabilities	64,766,470	76,315,606
Total Current Liabilities	240,172,251	241,604,637
Deferred Income Taxes	71,413,000	71,449,000
Long-Term Debt	866,421,839	866,473,465
Other Long-Term Liabilities	38,532,057	36,775,587
Total Liabilities	1,216,539,147	1,216,302,689
Stockholders' Equity		
Preferred stock, $0.05 par value; 10,000,000 shares authorized; no shares issued	—	—
Common stocks:		
Class A, $0.05 par value; 150,000,000 shares authorized; 14,071,251 shares issued and outstanding March 25, 2017; 13,966,476 shares issued and outstanding at September 24, 2016	703,563	698,324
Class B, convertible to Class A, $0.05 par value; 100,000,000 shares authorized; 6,188,525 shares issued and outstanding March 25, 2017; 6,293,300 shares	309,426	314,665

issued and outstanding at September 24, 2016		
Paid-in capital in excess of par value	12,311,249	12,311,249
Retained earnings	473,329,626	456,851,372
Total Stockholders’ Equity	486,653,864	470,175,610
Total Liabilities and Stockholders’ Equity	$ 1,703,193,011	$ 1,686,478,299

See notes to unaudited condensed consolidated financial statements.

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Three Months Ended	
	March 25, 2017	March 26, 2016
Net sales	$ 946,151,967	$ 924,312,049
Cost of goods sold	718,066,675	695,593,959
Gross profit	228,085,292	228,718,090
Operating and administrative expenses	203,023,241	196,147,853
(Loss) gain from sale or disposal of assets	(10,139)	557,409
Income from operations	25,051,912	33,127,646
Other income, net	776,316	534,097
Interest expense	11,719,781	11,225,332
Income before income taxes	14,108,447	22,436,411
Income tax expense	4,957,000	8,078,000
Net income	$ 9,151,447	$ 14,358,411
Per share amounts:		
Class A Common Stock		
Basic earnings per common share	$ 0.47	$ 0.73
Diluted earnings per common share	$ 0.45	$ 0.71
Class B Common Stock		
Basic earnings per common share	$ 0.42	$ 0.66
Diluted earnings per common share	$ 0.42	$ 0.66
Cash dividends per common share		
Class A Common Stock	$ 0.165	$ 0.165
Class B Common Stock	$ 0.150	$ 0.150

See notes to unaudited condensed consolidated financial statements.

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	Six Months Ended	
	March 25, 2017	March 26, 2016
Net sales	$ 1,928,910,306	$ 1,875,425,912
Cost of goods sold	1,463,740,533	1,421,068,490
Gross profit	465,169,773	454,357,422
Operating and administrative expenses	409,319,456	390,220,140
Gain from sale or disposal of assets	1,367,978	621,141
Income from operations	57,218,295	64,758,423
Other income, net	1,439,451	1,139,940
Interest expense	23,032,412	23,202,529
Income before income taxes	35,625,334	42,695,834
Income tax expense	12,650,000	15,358,000
Net income	$ 22,975,334	$ 27,337,834
Per share amounts:		
Class A Common Stock		
Basic earnings per common share	$ 1.17	$ 1.39
Diluted earnings per common share	$ 1.13	$ 1.35
Class B Common Stock		
Basic earnings per common share	$ 1.06	$ 1.26
Diluted earnings per common share	$ 1.06	$ 1.26
Cash dividends per common share		
Class A Common Stock	$ 0.33	$ 0.33
Class B Common Stock	$ 0.30	$ 0.30

See notes to unaudited condensed consolidated financial statements.

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (UNAUDITED)

SIX MONTHS ENDED MARCH 25, 2017 AND MARCH 26, 2016

	Class A Common Stock Shares	Class A Common Stock Amount	Class B Common Stock Shares	Class B Common Stock Amount	Paid-in Capital in Excess of Par Value	Retained Earnings	Total
Balance, September 26, 2015	13,924,651	$ 696,233	6,335,125	$ 316,756	$ 12,311,249	$ 415,654,162	$ 428,978,400
Net income	—	—	—	—	—	27,337,834	27,337,834
Cash dividends	—	—	—	—	—	(6,495,941)	(6,495,941)
Common stock conversions	18,175	909	(18,175)	(909)	—	—	—
Balance, March 26, 2016	13,942,826	$ 697,142	6,316,950	$ 315,847	$ 12,311,249	$ 436,496,055	$ 449,820,293
Balance, September 24, 2016	13,966,476	$ 698,324	6,293,300	$ 314,665	$ 12,311,249	$ 456,851,372	$ 470,175,610
Net income	—	—	—	—	—	22,975,334	22,975,334
Cash dividends	—	—	—	—	—	(6,497,080)	(6,497,080)
Common stock conversions	104,775	5,239	(104,775)	(5,239)	—	—	—
Balance, March 25, 2017	14,071,251	$ 703,563	6,188,525	$ 309,426	$ 12,311,249	$ 473,329,626	$ 486,653,864

See notes to unaudited condensed consolidated financial statements.

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INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	Six Months Ended	
	March 25, 2017	March 26, 2016
Cash Flows from Operating Activities:		
Net income	$ 22,975,334	$ 27,337,834
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	54,913,272	52,391,891
Gain from sale or disposal of assets	(1,367,978)	(621,141)
Receipt of advance payments on purchases contracts	1,170,000	2,500,000
Recognition of advance payments on purchases contracts	(1,265,876)	(1,634,696)
Deferred income taxes	(36,000)	3,648,000
Changes in operating assets and liabilities:		
Receivables	(1,808,619)	(4,204,142)
Inventory	(4,186,629)	(2,236,116)
Other assets	(6,802,871)	2,090,262
Accounts payable and accrued expenses	1,864,809	(21,644,196)
Net Cash Provided by Operating Activities	65,455,442	57,627,696
Cash Flows from Investing Activities:		
Proceeds from sales of property and equipment	1,481,305	643,492
Capital expenditures	(59,380,630)	(71,224,192)
Net Cash Used by Investing Activities	(57,899,325)	(70,580,700)
Cash Flows from Financing Activities:		
Proceeds from short-term borrowings	251,695,910	399,128,977
Payments on short-term borrowings	(244,497,799)	(369,559,814)
Principal payments on long-term borrowings	(7,832,397)	(8,558,415)
Dividends paid	(6,497,080)	(6,495,941)
Net Cash (Used) Provided by Financing Activities	(7,131,366)	14,514,807
Net Increase in Cash and Cash Equivalents	424,751	1,561,803
Cash and cash equivalents at beginning of period	5,679,509	7,505,040
Cash and Cash Equivalents at End of Period	$ 6,104,260	$ 9,066,843

See notes to unaudited condensed consolidated financial statements.

INGLES MARKETS, INCORPORATED AND SUBSIDIARIES

NOTES TO UNAUDITED INTERIM FINANCIAL STATEMENTS

Six Months Ended March 25, 2017 and March 26, 2016

A. BASIS OF PREPARATION

In the opinion of management, the accompanying unaudited interim financial statements contain all adjustments necessary to present fairly the financial position of Ingles Markets, Incorporated and Subsidiaries (the "Company") as of March 25, 2017, the results of operations for the three-month and six-month periods ended March 25, 2017 and March 26, 2016, and the changes in stockholders' equity and cash flows for the six-month periods ended March 25, 2017 and March 26, 2016. The adjustments made are of a normal recurring nature. Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission for Form 10-Q. It is suggested that these unaudited interim financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Annual Report on Form 10-K for the year ended September 24, 2016 filed by the Company under the Securities Exchange Act of 1934 on December 16, 2016.

The results of operations for the three-month and six-month periods ended March 25, 2017 are not necessarily indicative of the results to be expected for the full fiscal year.

B. NEW ACCOUNTING PRONOUNCEMENTS

In February 2016, the FASB issued Accounting Standards Update ASU 2016-02 "Leases" (ASU 2016-02). ASU 2016-02 requires lessees to recognize lease assets and lease liabilities on the balance sheet for those leases previously classified as operating leases. This ASU is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

In May 2014, the FASB issued Accounting Standards Update ASU 2014-09 "Revenue from Contracts with Customers" (ASU 2014-09). ASU 2014-09 is a comprehensive new revenue recognition model that requires a company to recognize to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be revenue entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14 which deferred the effective date of the ASU to fiscal years beginning after December 15, 2017 and interim periods within those fiscal years, with early adoption permitted. The Company is currently evaluating the impact of adopting this ASU on its consolidated financial statements.

C. ALLOWANCE FOR DOUBTFUL ACCOUNTS

Receivables are presented net of an allowance for doubtful accounts of $358,000 at March 25, 2017 and September 24, 2016.

D. INCOME TAXES

The Company's effective tax rate differs from the federal statutory rate primarily as a result of state income taxes and tax credits.

The Company has unrecognized tax benefits and could incur interest and penalties related to uncertain tax positions. These amounts are insignificant and are not expected to significantly increase or decrease within the next twelve months.

E. ACCRUED EXPENSES AND CURRENT PORTION OF OTHER LONG-TERM LIABILITIES

Accrued expenses and current portion of other long-term liabilities consist of the following:

	March 25, 2017	September 24, 2016
Property, payroll and other taxes payable	$ 11,012,798	$ 18,883,819
Salaries, wages and bonuses payable	24,672,366	28,159,164
Self-insurance liabilities	13,501,285	14,083,047
Interest payable	12,472,683	12,406,614
Other	3,107,338	2,782,962
	$ 64,766,470	$ 76,315,606

Self-insurance liabilities are established for general liability claims, workers' compensation and employee group medical and dental benefits based on claims filed and estimates of claims incurred but not reported. The Company is insured for covered costs in excess of $750,000 per occurrence for workers' compensation, $500,000 for general liability and $450,000 per covered person for medical care benefits for a policy year. The Company's self-insurance reserves totaled $35.9 million at March 25, 2017 and September 24, 2016. Of this amount, $13.5 million is accounted for as a current liability and $22.4 million as a long-term liability, which is inclusive of $5.0 million of expected self-insurance recoveries from excess cost insurance or other sources that are recorded as a receivable at March 25, 2017. At September 24, 2016, $14.1 million is accounted for as a current liability and $21.8 million as a long-term liability, which is inclusive of $4.8 million of expected self-insurance recoveries from excess cost insurance or other sources that are recorded as a receivable. Employee insurance expense, including workers' compensation and medical care benefits, net of employee contributions, totaled $7.1 million and $10.0 million for the three-month periods ended March 25, 2017 and March 26, 2016, respectively. For the six-month periods ended March 25, 2017 and March 26, 2016, employee insurance expense, net of employee contributions, totaled $16.4 million and $19.2 million, respectively.

F. LONG-TERM DEBT

In June 2013, the Company issued $700.0 million aggregate principal amount of senior notes due in 2023 (the "Notes") in a private placement. The Notes bear an interest rate of 5.750% per annum and were issued at par.

The Company filed a registration statement with the Securities and Exchange Commission and completed the exchange of private placement notes with registered notes.

The Company may redeem all or a portion of the Notes at any time on or after June 15, 2018 at the following redemption prices (expressed as percentages of the principal amount), if redeemed during the 12-month period beginning June 15 of the years indicated below:

Year	
2018	102.875%
2019	101.917%
2020	100.958%
2021 and thereafter	100.000%

The Company has a $175.0 million line of credit (the "Line") that matures in June 2018. The Line provides the Company with various interest rate options based on the prime rate, the Federal Funds Rate, or the London Interbank Offering Rate ("LIBOR"). The Line allows the Company to issue up to $30.0 million in unused letters of credit, of which $9.0 million of unused letters of credit were issued at March 25, 2017. The Company is not required to maintain compensating balances in connection with the Line. At March 25, 2017, the Company had $7.2 million of borrowings outstanding under the Line.

In December 2010, the Company completed the funding of $99.7 million of Recovery Zone Facility Bonds (the "Bonds") for construction of new warehouse and distribution space in Buncombe County, North Carolina (the "Project"). The final maturity date of the Bonds is January 1, 2036.

The Bonds were issued by the Buncombe County Industrial Facilities and Pollution Control Financing Authority and were purchased by certain financial institutions. Under a Continuing Covenant and Collateral Agency Agreement (the "Covenant Agreement") between the financial institutions and the Company, the financial institutions would hold the Bonds until June 30, 2021, subject to certain events. Mandatory redemption of the Bonds by the Company in the annual amount of $4.5 million began on January 1, 2014.

The Company may redeem the Bonds without penalty or premium at any time prior to June 2021.

Interest earned by bondholders on the Bonds is exempt from Federal and North Carolina income taxation. The interest rate on the Bonds is equal to one month LIBOR (adjusted monthly) plus a credit spread, adjusted to reflect the income tax exemption.

The Company's obligation to repay the Bonds is collateralized by the Project. Additional collateral was required in order to meet certain loan to value criteria in the Covenant Agreement. The Covenant Agreement incorporates substantially all financial covenants included in the Line.

The Notes, the Bonds and the Line contain provisions that under certain circumstances would permit lending institutions to terminate or withdraw their respective extensions of credit to the Company. Included among the triggering factors permitting the termination or withdrawal of the Line to the Company are certain events of default, including both monetary and non-monetary defaults, the initiation of bankruptcy or insolvency proceedings, and the failure of the Company to meet certain financial covenants designated in its respective loan documents. The Company was in compliance with all financial covenants related to its borrowings at March 25, 2017.

The Company's long-term debt agreements generally have cross-default provisions which could result in the acceleration of payments due under the Company's Line, Bonds and Notes indenture in the event of default under any one instrument.

G. DIVIDENDS

The Company paid cash dividends of $0.165 for each share of Class A Common Stock and $0.15 for each share of Class B Common Stock on October 14, 2016 to stockholders of record on October 6, 2016.

The Company paid cash dividends of $0.165 for each share of Class A Common Stock and $0.15 for each share of Class B Common Stock on January 12, 2017 to stockholders of record on January 6, 2017.

For additional information regarding the dividend rights of the Class A Common Stock and Class B Common Stock, please see Note 8, "Stockholders' Equity" to the Consolidated Financial Statements of the Annual Report on Form 10-K filed by the Company under the Securities Exchange Act of 1934 on December 16, 2016.

H. EARNINGS PER COMMON SHARE

The Company has two classes of common stock: Class A which is publicly traded, and Class B, which has no public market. The Class B Common Stock has restrictions on transfer; however, each share is convertible into one share of Class A Common Stock at any time. Each share of Class A Common Stock has one vote per share and each share of Class B Common Stock has ten votes per share. Each share of Class A Common Stock is entitled to receive cash dividends equal to 110% of any cash dividend paid on Class B Common Stock.

The Company calculates earnings per share using the two-class method in accordance with FASB Accounting Standards Codification ("FASB ASC") Topic 260.

The two-class method of computing basic earnings per share for each period reflects the cash dividends paid per share for each class of stock, plus the amount of allocated undistributed earnings per share computed using the participation percentage which reflects the dividend rights of each class of stock. Diluted earnings per share is calculated assuming conversion of all shares of Class B Common Stock to shares of Class A Common Stock on a share-for-share basis. The tables below reconcile the numerators and denominators of basic and diluted earnings per share for current and prior periods.

	Three Months Ended	Six Months Ended

	March 25, 2017		March 25, 2017	
	Class A	Class B	Class A	Class B
Numerator: Allocated net income				
Net income allocated, basic	$ 6,513,698	$ 2,637,749	$ 16,328,364	$ 6,646,970
Conversion of Class B to Class A shares	2,637,749	—	6,646,970	—
Net income allocated, diluted	$ 9,151,447	$ 2,637,749	$ 22,975,334	$ 6,646,970
Denominator: Weighted average shares outstanding				
Weighted average shares outstanding, basic	14,038,094	6,221,682	14,002,300	6,257,476
Conversion of Class B to Class A shares	6,221,682	—	6,257,476	—
Weighted average shares outstanding, diluted	20,259,776	6,221,682	20,259,776	6,257,476
Earnings per share				
Basic	$ 0.47	$ 0.42	$ 1.17	$ 1.06
Diluted	$ 0.45	$ 0.42	$ 1.13	$ 1.06

The per share amounts for the second quarter of fiscal 2016 and the six months ended March 26, 2016 are based on the following amounts:

	Three Months Ended March 26, 2016		Six Months Ended March 26, 2016	
	Class A	Class B	Class A	Class B
Numerator: Allocated net income				
Net income allocated, basic	$ 10,169,757	$ 4,188,654	$ 19,352,122	$ 7,985,712
Conversion of Class B to Class A shares	4,188,654	—	7,985,712	—
Net income allocated, diluted	$ 14,358,411	$ 4,188,654	$ 27,337,834	$ 7,985,712
Denominator: Weighted average shares outstanding				
Weighted average shares outstanding, basic	13,942,826	6,316,950	13,934,874	6,324,902
Conversion of Class B to Class A shares	6,316,950	—	6,324,902	—
Weighted average shares outstanding, diluted	20,259,776	6,316,950	20,259,776	6,324,902
Earnings per share				
Basic	$ 0.73	$ 0.66	$ 1.39	$ 1.26
Diluted	$ 0.71	$ 0.66	$ 1.35	$ 1.26

I. SEGMENT INFORMATION

The Company operates one primary business segment, retail grocery sales. The "Other" activities include fluid dairy and shopping center rentals. Information about the Company's operations by lines of business (amounts in thousands) is as follows:

	Three Months Ended		Six Months Ended	
	March 25, 2017	March 26, 2016	March 25, 2017	March 26, 2016
Revenues from unaffiliated customers:				

Grocery	$ 342,188	$ 351,123	$ 703,089	$ 709,585
Non-foods	201,258	198,158	413,568	401,026
Perishables	248,673	248,343	504,522	495,227
Gasoline	118,083	92,187	236,606	200,704
Total Retail	$ 910,202	$ 889,811	$ 1,857,785	$ 1,806,542
Other	35,950	34,501	71,125	68,884
Total revenues from unaffiliated customers	$ 946,152	$ 924,312	$ 1,928,910	$ 1,875,426
Income from operations:				
Retail	$ 20,606	$ 28,869	$ 49,597	$ 56,638
Other	4,446	4,259	7,621	8,120
Total income from operations	$ 25,052	$ 33,128	$ 57,218	$ 64,758

	March 25, 2017	September 24, 2016
Assets:		
Retail	$ 1,570,727	$ 1,555,319
Other	134,135	133,574
Elimination of intercompany receivable	(1,669)	(2,415)
Total assets	$ 1,703,193	$ 1,686,478

The grocery category includes grocery, dairy, and frozen foods.

The non-foods include alcoholic beverages, tobacco, pharmacy, health and video.

The perishables category includes meat, produce, deli and bakery.

For the three-month periods ended March 25, 2017 and March 26, 2016, respectively, the fluid dairy had $11.5 million and $11.0 million in sales to the retail grocery segment. The fluid dairy had $23.3 million and $22.3 million in sales to the retail grocery segment for the six-month periods ended March 25, 2017 and March 26, 2016, respectively. These sales have been eliminated in consolidation.

J. FAIR VALUES OF FINANCIAL INSTRUMENTS

The carrying amounts for cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturity of these instruments.

The fair value of the Company's debt is estimated using valuation techniques under the accounting guidance related to fair value measurements based on observable and unobservable inputs. Observable inputs reflect readily available data from independent sources, while unobservable inputs reflect the Company's market assumptions. These inputs are classified into the following hierarchy:

Level 1 Inputs –	Quoted prices for identical assets or liabilities in active markets.

Level 2 Inputs – Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and model-derived valuations whose inputs are observable or whose significant value drivers are observable.

Level 3 Inputs – Pricing inputs are unobservable for the assets or liabilities and include situations where there is little, if any, market activity for the assets or liabilities. The inputs into the determination of fair value require significant management judgment or estimation.

The carrying amount and fair value of the Company’s debt at March 25, 2017 is as follows (in thousands):

	Carrying Amount	Fair Value	Fair Value Measurements
Senior Notes	$ 700,000	$ 700,875	Level 2
Facility Bonds	81,620	81,620	Level 2
Secured notes payable and other	87,665	87,665	Level 2
Line of credit payable	7,198	7,198	Level 2
Total debt	$ 876,483	$ 877,358	

The fair values for Level 2 measurements were determined primarily using market yields and taking into consideration the underlying terms of the debt.

K. SUBSEQUENT EVENTS

We have evaluated subsequent events and transactions for potential recognition or disclosure in the financial statements through the day the financial statements were issued.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Overview

Ingles, a leading supermarket chain in the Southeast, operates 201 supermarkets in Georgia (71), North Carolina (71), South Carolina (36), Tennessee (21), Virginia (1) and Alabama (1). The Company locates its supermarkets primarily in suburban areas, small towns and rural communities. Ingles supermarkets offer customers a wide variety of nationally advertised food products, including grocery, meat and dairy products, produce, frozen foods and other perishables and non-food products. Non-food products include fuel centers, pharmacies, health and beauty care products and general merchandise. In addition, the Company focuses on selling high-growth, high-margin products to its customers through the development of certified organic products, bakery departments and prepared foods including delicatessen sections. As of March 25, 2017, the Company operated 101 in-store pharmacies and 96 fuel centers.

Ingles also operates a fluid dairy and earns shopping center rentals. The fluid dairy processing operation sells approximately 25% of its products to the retail grocery segment and approximately 75% of its products to third parties. Real estate ownership is an important component of the Company's operations, providing both operational and economic benefits.

Critical Accounting Policies

Critical accounting policies are those accounting policies that management believes are important to the portrayal of the Company's financial condition and results of operations, and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Estimates are based on historical experience and other factors believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Management estimates, by their nature, involve judgments regarding future uncertainties, and actual results may therefore differ materially from these estimates.

Self-Insurance

The Company is self-insured for workers' compensation and group medical and dental benefits. Risks and uncertainties are associated with self-insurance; however, the Company has limited its exposure by maintaining excess liability coverage of $750,000 per occurrence for workers' compensation, $500,000 for general liability, and $450,000 per covered person for medical care benefits for a policy year. Self-insurance liabilities are established based on claims filed and estimates of claims incurred but not reported. The estimates are based on data provided by the respective claims administrators. These estimates can fluctuate if historical trends are not predictive of the future. The majority of the Company's properties are self-insured for casualty losses and business interruption; however, liability coverage is maintained. At March 25, 2017, the Company's self-insurance reserves totaled $35.9 million. Of this amount, $13.5 million is accounted for as a current liability and $22.4 million as a long-term liability, which is inclusive of $5.0 million of expected self-insurance recoveries from excess cost insurance or other sources that are recoded as a receivable at March 25, 2017.

Asset Impairments

The Company accounts for the impairment of long-lived assets in accordance with FASB ASC Topic 360. For assets to be held and used, the Company tests for impairment using undiscounted cash flows and calculates the amount of impairment using discounted cash flows. For assets held for sale, impairment is recognized based on the excess of remaining book value over expected recovery value. The recovery value is the fair value as determined by independent quotes or expected sales prices developed by internal associates. Estimates of future cash flows and expected sales prices are judgments based upon the Company's experience and knowledge of local operations and cash flows that are projected for several years into the future. These estimates can fluctuate significantly due to changes in real estate market conditions, the economic environment, capital spending decisions and inflation. The Company monitors the carrying value of long-lived assets for potential impairment each quarter based on whether any indicators of impairment have occurred. There were no asset impairments during the six-month period ended March 25, 2017.

Vendor Allowances

The Company receives funds for a variety of merchandising activities from the many vendors whose products the Company buys for resale in its stores. These incentives and allowances are primarily comprised of volume or purchase based incentives, advertising allowances, slotting fees, and promotional discounts. The purpose of these incentives and allowances is generally to help defray the costs incurred by the Company for stocking, advertising, promoting and selling the vendor's products. These allowances generally relate to short term arrangements with vendors, often relating to a period of a month or less, and are negotiated on a purchase-by-purchase or transaction-by-transaction basis. Whenever possible, vendor discounts and allowances that relate to buying and merchandising activities are recorded as a component of item cost in inventory and recognized in merchandise costs when the item is sold. Due to system constraints and the nature of certain allowances, it is sometimes not practicable to apply allowances to the item cost of inventory. In those instances, the allowances are applied as a reduction of merchandise costs using a rational and systematic methodology, which results in the recognition of these incentives when the inventory related to the vendor consideration received is sold. Vendor allowances applied as a reduction of merchandise costs totaled \$29.0 million and \$28.9 million for the fiscal quarters ended March 25, 2017 and March 26, 2016, respectively. For the six-month periods ended March 25, 2017 and March 26, 2016, vendor allowances applied as a reduction of merchandise costs totaled \$59.7 million and \$58.5 million, respectively. Vendor advertising allowances that represent a reimbursement of specific identifiable incremental costs of advertising the vendor's specific products are recorded as a reduction to the related expense in the period in which the related expense is incurred. Vendor advertising allowances recorded as a reduction of advertising expense totaled \$3.2 million and \$3.1 million for the fiscal quarters ended March 25, 2017 and March 26, 2016, respectively. For the six-month periods ended March 25, 2017 and March 26, 2016, vendor advertising allowances recorded as a reduction of advertising expense totaled \$7.1 million and \$6.8 million, respectively.

If vendor advertising allowances were substantially reduced or eliminated, the Company would likely consider other methods of advertising, as well as the volume and frequency of the Company's product advertising, which could increase or decrease the Company's expenditures.

Similarly, the Company is not able to assess the impact of vendor advertising allowances on creating additional revenue; as such allowances do not directly generate revenue for the Company's stores.

Results of Operations

Ingles operates on a 52- or 53-week fiscal year ending on the last Saturday in September. There are 13 and 26 weeks of operations included in the Unaudited Condensed Consolidated Statements of Income for the three- and six-month periods ended March 25, 2017 and March 26, 2016, respectively. Comparable store sales are defined as sales by grocery stores in operation for five full fiscal quarters. Sales from replacement stores, major remodels and the addition of fuel stations to existing stores are included in the comparable store sales calculation from the date thereof. A replacement store is a new store that is opened to replace an existing nearby store that is closed. A major remodel entails substantial remodeling of an existing store and includes additional retail square footage. For the three- and six-month periods ended March 25, 2017 and March 26, 2016, comparable store sales include 199 and 200 stores, respectively.

The following table sets forth, for the periods indicated, selected financial information as a percentage of net sales. For information regarding the various segments of the business, see Note I "Segment Information" to the Unaudited Condensed Consolidated Financial Statements.

	Three Months Ended		Six Months Ended	
	March 25, 2017	March 26, 2016	March 25, 2017	March 26, 2016
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Gross profit	24.1 %	24.7 %	24.1 %	24.2 %
Operating and administrative expenses	21.5 %	21.2 %	21.2 %	20.8 %
Income from operations	2.6 %	3.6 %	3.0 %	3.5 %
Other income, net	0.1 %	0.1 %	0.1 %	0.1 %
Interest expense	1.2 %	1.2 %	1.2 %	1.2 %
Income tax expense	0.5 %	0.9 %	0.7 %	0.8 %
Net income	1.0 %	1.6 %	1.2 %	1.5 %

Three Months Ended March 25, 2017 Compared to the Three Months Ended March 26, 2016

Net income for the second quarter of fiscal 2017 totaled $9.2 million, compared with net income of $14.4 million earned for the second quarter of fiscal 2016. Retail dollar sales and gross profit (both excluding gasoline) decreased slightly, partly due to the timing of the Easter holiday. The 2016 Easter holiday occurred in March so last year's second quarter benefited from the extra sales and gross profit. The 2017 Easter holiday occurred in April, so this year's third quarter will benefit. Operating expenses also increased, primarily in personnel costs.

Net Sales. Net sales increased by $21.9 million, or 2.4% to $946.2 million for the three months ended March 25, 2017 from $924.3 million for the three months ended March 26, 2016. Higher gasoline sales (in both dollars and gallons) helped offset the Easter effect on sales described above. Comparing the second quarter of fiscal 2017 with the second quarter of fiscal 2016, gasoline sales dollars increased 28.3% due to a 25.5% increase in the average sales price per gallon. Gallons sold increased 2.3% over the same comparable periods. Excluding gasoline sales and the effect of extra Easter sales in fiscal 2016, total grocery comparable store sales decreased

0.3% over the comparative fiscal second quarters. Comparing the second quarters of fiscal year 2017 and 2016 (and excluding gasoline), the number of customer transactions increased 0.2% and the average transaction size decreased 0.8%.

Ingles operated 201 and 202 stores at March 25, 2017 and March 26, 2016, respectively. Retail square feet totaled 11.2 million square feet at March 25, 2017 and 11.1 million square feet at March 26, 2016. During the last twelve months the Company opened one store and closed two stores, one of which is being rebuilt and will open later this fiscal year.

Sales by product category (amounts in thousands) are as follows:

	Three Months Ended	
	March 25, 2017	March 26, 2016
Grocery	$ 342,188	$ 351,123
Non-foods	201,258	198,158
Perishables	248,673	248,343
Gasoline	118,083	92,187
Total retail	$ 910,202	$ 889,811

The grocery category includes grocery, dairy and frozen foods.

The non-foods category includes alcoholic beverages, tobacco, pharmacy, health and video.

The perishables category includes meat, produce, deli and bakery.

Changes in retail sales for the quarter ended March 25, 2017 are summarized as follows (in thousands):