

SPARTAN STORES INC
Form 10-Q
February 03, 2006

**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 December 31, 2005.

OR

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

For the transition period from _____ to _____.

Commission File Number: 000-31127

SPARTAN STORES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Michigan

(State or Other Jurisdiction
of Incorporation or Organization)

38-0593940

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

850 76th Street, S.W.

P.O. Box 8700

Grand Rapids, Michigan

(Address of Principal Executive Offices)

49518

(Zip Code)

(616) 878-2000

(Registrant's Telephone Number, Including Area Code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act).

Yes No

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

Yes No

As of January 27, 2006 the registrant had 20,814,894 outstanding shares of Common Stock, no par value.

FORWARD-LOOKING STATEMENTS

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

In addition to other risks and uncertainties described in connection with the forward-looking statements contained in this Quarterly Report on Form 10-Q, Spartan Stores' Annual Report on Form 10-K for the year ended March 26, 2005 and other periodic reports filed with the Securities and Exchange Commission, there are many important factors that could cause actual results to differ materially. Our ability to strengthen our retail-store performance; maintain or grow sales; maintain or increase gross margin; maintain and improve customer and supplier relationships; reduce operating costs; sell on favorable terms assets classified as held for sale; generate cash; continue to meet the terms of our debt covenants; and implement the other programs, plans, strategies, objectives, goals or expectations described in this Quarterly Report, our press releases and our public comments will be affected by changes in economic conditions generally or in the markets and geographic areas that we serve, adverse effects of the changing food and distribution industries and other factors including, but not limited to, those discussed below.

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

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

Our ability to complete the proposed acquisition of certain of the assets of D&W Food Centers, Inc. ("D&W") depends on satisfaction of a variety of contractual conditions, not all of which are entirely within the control of us or D&W. Realization of increased sales and earnings, as a result of that transaction, depends on our ability to successfully complete the transaction, integrate the acquired assets, and implement our plans and business practices.

Our adoption of a dividend policy on December 13, 2005 does not commit the Board of Directors to declare future dividends. Each future dividend will be considered and declared by the Board of Directors in its discretion. The ability of the Board of Directors to continue to declare dividends will depend on a number of factors, including our future financial condition and profitability and compliance with the terms of our credit facilities.

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

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

PART I
FINANCIAL INFORMATION

ITEM 1. Financial Statements

SPARTAN STORES, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)
(Unaudited)

| <u>Assets</u> | <u>December 31, 2005</u> | <u>March 26, 2005</u> |
|--|------------------------------|---------------------------|
| Current assets | | |
| Cash and cash equivalents | \$ 11,782 | \$ 14,880 |
| Accounts receivable, net | 41,075 | 43,445 |
| Inventories, net | 104,004 | 95,988 |
| Prepaid expenses and other current assets | 5,424 | 7,884 |
| Deferred taxes on income | 5,604 | 5,396 |
| Property and equipment held for sale | 4,668 | 3,855 |
| Total current assets | 172,557 | 171,448 |
| Other assets | | |
| Goodwill | 72,465 | 72,315 |
| Deferred taxes on income | 12,087 | 18,680 |
| Other, net | 13,369 | 13,135 |
| Total other assets | 97,921 | 104,130 |
| Property and equipment, net | 108,394 | 108,879 |
| Total assets | \$ 378,872 | \$ 384,457 |
| <u>Liabilities and Shareholders' Equity</u> | | |
| Current liabilities | | |
| Accounts payable | \$ 88,751 | \$ 82,391 |
| Accrued payroll and benefits | 25,420 | 30,775 |
| Other accrued expenses | 27,340 | 25,176 |
| Current maturities of long-term debt | 1,654 | 2,848 |
| Total current liabilities | 143,165 | 141,190 |
| Other long-term liabilities | 11,596 | 16,814 |
| Postretirement benefits | 10,054 | 9,097 |
| Long-term debt | 74,867 | 91,946 |

Shareholders' equity

| | | |
|--|----------------|----------------|
| Common stock, voting, no par value; 50,000 shares authorized; 20,812 and 20,524 shares outstanding | 121,513 | 118,144 |
| Preferred stock, no par value, 10,000 shares authorized; no shares outstanding | - | - |
| Deferred stock-based compensation | (3,170) | (719) |
| Accumulated other comprehensive loss | (203) | (203) |
| Retained earnings | 21,050 | 8,188 |
| | <hr/> | <hr/> |
| Total shareholders' equity | 139,190 | 125,410 |
| | <hr/> | <hr/> |

| | | |
|---|-------------------|-------------------|
| Total liabilities and shareholders' equity | \$ 378,872 | \$ 384,457 |
| | <hr/> | <hr/> |

See accompanying notes to condensed consolidated financial statements.

SPARTAN STORES, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF EARNINGS

(In thousands, except per share data)

(Unaudited)

| | 16 Weeks Ended | | 40 Weeks Ended | |
|---|----------------------|--------------------|----------------------|--------------------|
| | December 31, 2005 | January 1, 2005 | December 31, 2005 | January 1, 2005 |
| Net sales | \$ 642,274 | \$ 624,517 | \$ 1,587,135 | \$ 1,585,543 |
| Cost of sales | 526,530 | 507,165 | 1,292,038 | 1,287,200 |
| Gross margin | 115,744 | 117,352 | 295,097 | 298,343 |
| Operating expenses | | | | |
| Selling, general and administrative expenses | 106,592 | 105,912 | 267,434 | 268,780 |
| Provision for asset impairments and exit costs | 787 | - | 1,057 | - |
| Total operating expenses | 107,379 | 105,912 | 268,491 | 268,780 |
| Operating earnings | 8,365 | 11,440 | 26,606 | 29,563 |
| Other income and expenses | | | | |
| Interest expense | 2,538 | 2,897 | 6,070 | 7,466 |
| Debt extinguishment | - | 561 | - | 561 |
| Other, net | (1,294) | (939) | (1,349) | (910) |
| Total other income and expenses | 1,244 | 2,519 | 4,721 | 7,117 |
| Earnings before income taxes and discontinued operations | 7,121 | 8,921 | 21,885 | 22,446 |
| Income taxes | 2,351 | 3,123 | 7,232 | 7,855 |
| Earnings from continuing operations | 4,770 | 5,798 | 14,653 | 14,591 |
| Loss from discontinued operations, net of taxes | (1,413) | (1,273) | (1,791) | (1,562) |
| Net earnings | \$ 3,357 | \$ 4,525 | \$ 12,862 | \$ 13,029 |
| Basic earnings per share: | | | | |
| Earnings from continuing operations | \$ 0.23 | \$ 0.28 | \$ 0.71 | \$ 0.72 |
| Loss from discontinued operations | (0.07) | (0.06) | (0.09) | (0.08) |
| Net earnings | \$ 0.16 | \$ 0.22 | \$ 0.62 | \$ 0.64 |

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Diluted earnings per share:

| | | | | | | | | |
|-------------------------------------|----|--------|----|--------|----|--------|----|--------|
| Earnings from continuing operations | \$ | 0.22 | \$ | 0.28 | \$ | 0.69 | \$ | 0.71 |
| Loss from discontinued operations | | (0.06) | | (0.06) | | (0.09) | | (0.08) |
| <hr/> | | | | | | | | |
| Net earnings | \$ | 0.16 | \$ | 0.22 | \$ | 0.60 | \$ | 0.63 |
| <hr/> | | | | | | | | |

Weighted average shares outstanding:

| | | | | |
|---------|--------|--------|--------|--------|
| Basic | 20,812 | 20,498 | 20,758 | 20,416 |
| Diluted | 21,321 | 20,795 | 21,330 | 20,658 |

See accompanying notes to condensed consolidated financial statements.

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

| | Shares Outstanding | Common Stock | Deferred Stock-Based Compensation | Accumulated Other Comprehensive Loss | Retained Earnings | Total |
|--|-----------------------|-----------------|---|---|----------------------|------------|
| Balance - March 27, 2005 | 20,524 | \$ 118,144 | \$ (719) | \$ (203) | \$ 8,188 | \$ 125,410 |
| Comprehensive income, net of tax: | | | | | | |
| Net earnings for fiscal 2006 | - | - | - | - | 12,862 | 12,862 |
| Issuances of common stock | 43 | 317 | - | - | - | 317 |
| Issuances of restricted stock | 252 | 3,060 | (3,060) | - | - | - |
| Cancellations of restricted stock | (7) | (8) | 8 | - | - | - |
| Amortization of restricted stock | - | - | 601 | - | - | 601 |
| Balance - December 31, 2005 | 20,812 | \$ 121,513 | \$ (3,170) | \$ (203) | \$ 21,050 | \$ 139,190 |

See accompanying notes to condensed consolidated financial statements.

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

(In thousands)

(Unaudited)

| | 40 Weeks Ended | |
|---|----------------------|--------------------|
| | December 31, 2005 | January 1, 2005 |
| Cash flows from operating activities | | |
| Net earnings | \$ 12,862 | \$ 13,029 |
| Loss from discontinued operations | 1,791 | 1,562 |
| | 14,653 | 14,591 |
| Earnings from continuing operations | 14,653 | 14,591 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Debt extinguishment | - | 561 |
| Provision for asset impairments and exit costs | 1,057 | - |
| Depreciation and amortization | 16,089 | 17,627 |
| Postretirement benefits | 957 | 912 |
| Deferred taxes on income | 6,665 | 6,896 |
| Restricted stock amortization | 601 | 141 |
| Gain/loss on sale of assets | (1,218) | (770) |
| Other, net | 368 | (41) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 2,332 | (2,535) |
| Inventories | (8,016) | 1,121 |
| Prepaid expenses and other assets | 916 | 3,561 |
| Accounts payable | 4,826 | 4,960 |
| Accrued payroll and benefits | (5,234) | 1,477 |
| Other accrued expenses and other liabilities | (822) | (1,096) |
| | 33,174 | 47,405 |
| Net cash provided by operating activities | 33,174 | 47,405 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (16,975) | (17,771) |
| Net proceeds from the sale of assets | 2,324 | 2,832 |
| Other | (114) | (205) |
| | (14,765) | (15,144) |
| Net cash used in investing activities | (14,765) | (15,144) |
| Cash flows from financing activities | | |
| Net payments on revolver | (15,975) | (8,602) |
| Repayment of long-term debt | (1,882) | (18,438) |
| Financing fees paid | - | (492) |
| Proceeds from sale of common stock | 317 | 636 |
| | (17,540) | (26,896) |
| Net cash used in financing activities | (17,540) | (26,896) |

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Discontinued operations

| | | |
|---|------------------|------------------|
| Net cash used in discontinued operations | (3,967) | (4,041) |
| <hr/> | | |
| Net (decrease) increase in cash and cash equivalents | (3,098) | 1,324 |
| Cash and cash equivalents at beginning of period | 14,880 | 13,252 |
| <hr/> | | |
| Cash and cash equivalents at end of period | \$ 11,782 | \$ 14,576 |
| <hr/> | | |

See accompanying notes to condensed consolidated financial statements.

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

Note 1**Basis of Presentation and Significant Accounting Policies**

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

In the opinion of management, the accompanying condensed consolidated financial statements, taken as a whole, contain all adjustments, which are of a normal recurring nature, necessary to present fairly the financial position of Spartan Stores as of December 31, 2005 and the results of its operations and cash flows for the interim periods presented. Interim results are not necessarily indicative of results for a full year.

Stock-Based Compensation

Spartan Stores has a stock incentive plan, which is more fully described in Note 10 of the 2005 Annual Report on Form 10-K. Spartan Stores accounts for the plan under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related Interpretations. No stock-based compensation cost for stock options is reflected in the Consolidated Statements of Earnings, as all options granted under the plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net earnings and earnings per share as if Spartan Stores had applied the fair value recognition principles of Statement of Financial Accounting Standards Statement No. 123, "Accounting for Stock-Based Compensation," to stock options granted to employees:

(In thousands, except per share data)

| | 16 Weeks Ended | |
|---|------------------------------|----------------------------|
| | December 31, 2005 | January 1, 2005 |
| Net earnings, as reported | \$ 3,357 | \$ 4,525 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (116) | (91) |
| Pro forma net earnings | <u>\$ 3,241</u> | <u>\$ 4,434</u> |
| Basic earnings per share - as reported | \$ 0.16 | \$ 0.22 |
| Basic earnings per share - pro forma | 0.16 | 0.22 |
| Diluted earnings per share - as reported | \$ 0.16 | \$ 0.22 |
| Diluted earnings per share - pro forma | 0.15 | 0.21 |

(In thousands, except per share data)

| | 40 Weeks Ended | |
|---|------------------------------|----------------------------|
| | December 31, 2005 | January 1, 2005 |
| Net earnings, as reported | \$ 12,862 | \$ 13,029 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (285) | (253) |
| Pro forma net earnings | \$ 12,577 | \$ 12,776 |
| Basic earnings per share - as reported | \$ 0.62 | \$ 0.64 |
| Basic earnings per share - pro forma | \$ 0.61 | \$ 0.63 |
| Diluted earnings per share - as reported | \$ 0.60 | \$ 0.63 |
| Diluted earnings per share - pro forma | \$ 0.59 | \$ 0.62 |

Reclassifications

Certain reclassifications have been made to the fiscal 2005 condensed consolidated financial statements to conform to the fiscal 2006 presentation.

Note 2**New Accounting Standards**

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment" that will require compensation costs related to share-based payment transactions to be recognized in the consolidated financial statements. With limited exceptions, the amount of compensation cost will be measured based on the grant date fair value of the equity or liability instruments issued. In addition, liability awards will be remeasured each reporting period. Compensation cost will be recognized over the period that an employee provides services in exchange for the award. SFAS No. 123(R) replaces SFAS No. 123, and supercedes APB Opinion No. 25. This Statement becomes effective for Spartan Stores at the beginning of fiscal 2007.

Spartan Stores intends to adopt SFAS No. 123(R) using the "modified prospective" transition method beginning with the first quarter of fiscal 2007. Under this method, awards that are modified, granted, or settled on or after March 26, 2006 will be measured and accounted for in accordance with SFAS No. 123(R). In addition, in Spartan Stores' first quarter of fiscal 2007, expense must be recognized for unvested awards that were granted prior to Spartan Stores' adoption of SFAS No. 123(R), and the expense will be based on the fair value determined at the grant date under SFAS No. 123, "Accounting for Stock-Based Compensation." As permitted by SFAS No. 123, Spartan Stores currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, recognizes no compensation cost for employee stock options. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. Had Spartan Stores adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in Note 1 to our consolidated financial statements. However, the calculation of compensation cost for share-based payment transactions after the effective date of SFAS No. 123(R) may be different from the calculation of compensation cost under SFAS No. 123, and such differences have not yet been quantified.

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In June 2005, the Emerging Issues Task Force ("EITF") reached a consensus on EITF Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination" ("EITF 05-6"). EITF 05-6 requires that leasehold improvements acquired in a business combination be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date of acquisition. EITF 05-6 also requires that leasehold

improvements that are placed in service significantly after and not contemplated at or near the beginning of the lease term be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date the leasehold improvements are purchased. EITF 05-6 became effective for Spartan Stores' fiscal quarter beginning September 11, 2005. The adoption of EITF 05-6 did not have a material effect on Spartan Stores' consolidated financial statements.

In October 2005, the FASB issued FASB Staff Position FAS 13-1, "Accounting for Rental Costs Incurred During a Construction Period" ("FSP FAS 13-1"). FSP FAS 13-1 requires rental costs associated with building or ground leases incurred during a construction period to be recognized as rental expense. FSP FAS 13-1 is effective for the first reporting period beginning after December 15, 2005; however, a lessee is required to cease capitalizing rental costs as of December 15, 2005 for operating lease arrangements entered into prior to December 15, 2005. Early adoption is permitted for annual or interim financial statements that have not yet been issued. Spartan Stores will adopt FSP FAS 13-1 beginning with the fiscal fourth quarter beginning January 1, 2006. The impact of FSP FAS 13-1 is not expected to have a material effect on Spartan Stores' consolidated financial statements.

Note 3

Long-Term Debt

Effective December 9, 2005, Spartan Stores amended its existing senior secured revolving credit facility. The amendment increased the senior secured revolving credit facility ("credit facility") to \$225.0 million from its original \$215.0 million and now matures in December 2010 rather than December 2008. In addition, a \$15.0 million Term B loan is included as part of the total \$225.0 million credit facility, which may be drawn upon at Spartan Stores' option through June 1, 2006. The amended agreement provides increased flexibility for engaging in acquisitions and paying cash dividends. In addition, the amended agreement increases availability of credit on fixed assets, and increases the advance rates on certain categories of assets, resulting in additional availability. Interest rates under the amended agreement may be up to 50 basis points lower for LIBOR borrowings depending on levels of excess availability under the agreement.

Available borrowings under the credit facility are based on stipulated advance rates on eligible assets, as defined in the credit agreement. The credit facility contains covenants that include the maintenance of minimum EBITDA and maximum capital expenditures, as defined in the credit agreement. These covenants will not be effective as long as Spartan Stores maintains a minimum excess availability level, as defined in the credit agreement. Spartan Stores had available borrowings of \$107.8 million at December 31, 2005 and maximum availability of \$117.8 million, which exceeds the minimum excess availability levels. The credit facility provides for the issuance of letters of credit of which \$10.5 million were outstanding and unused as of December 31, 2005. The credit facility bears interest at the London InterBank Offered Rate ("LIBOR") plus 1.50% or the prime rate (weighted average interest rate of 6.05% at December 31, 2005).

Spartan Stores' long-term debt consists of the following:

| (In thousands) | December 31, 2005 | March 26, 2005 |
|--|----------------------|-------------------|
| | _____ | _____ |
| Senior secured revolving credit facility, due December 2010 | \$ 66,061 | \$ 82,036 |
| Notes payable, due June 2007, monthly principal payments of variable amounts | 3,880 | 4,223 |
| Other | 6,580 | 8,535 |
| | _____ | _____ |
| | 76,521 | 94,794 |
| Less current portion | 1,654 | 2,848 |

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| | | |
|----------------------|------------------|------------------|
| Total long-term debt | <u>\$ 74,867</u> | <u>\$ 91,946</u> |
|----------------------|------------------|------------------|

At December 31, 2005 long-term debt was due as follows:

(In thousands)

| Fiscal Year | | |
|-------------|----|--------|
| 2006 | \$ | 450 |
| 2007 | | 2,135 |
| 2008 | | 4,135 |
| 2009 | | 591 |
| 2010 | | 66,707 |
| Thereafter | | 2,503 |
| | \$ | 76,521 |

Note 4 **Sale of Joint Venture**

Effective December 2004, Spartan Stores sold its 65 percent ownership interest in a retail store to its former joint venture partner. Total consideration of \$4.5 million from the transaction was used to reduce outstanding debt. As a result of this sale, Spartan Stores recorded a pre-tax gain of \$0.8 million in the third quarter of fiscal 2005 that is included in Other, net on the Consolidated Statements of Earnings. Spartan Stores' annualized retail sales and after-tax net earnings from the joint venture approximated \$20.0 million and \$0.3 million, respectively. Spartan Stores entered into a 10-year distribution supply agreement with the acquirer.

Note 5 **Discontinued Operations**

Spartan Stores' former convenience distribution operations, insurance operations and certain of its retail, grocery distribution and real estate operations have been recorded as discontinued operations. Results of the discontinued operations are excluded from the accompanying notes to the consolidated financial statements for all periods presented, unless otherwise noted.

Discontinued operations had no sales during the third quarter and year-to-date periods ended December 31, 2005 and January 1, 2005. The operating losses in discontinued operations for the third quarters ended December 31, 2005 and January 1, 2005 of \$2.1 million and \$2.0 million were partially offset by income tax benefits of \$0.7 million and \$0.7 million for the third quarters ended December 31, 2005 and January 1, 2005, respectively. The operating losses in discontinued operations for the year-to-date periods ended December 31, 2005 and January 1, 2005 of \$2.7 million and \$2.4 million were partially offset by income tax benefits of \$0.9 million and \$0.8 million for the year-to-date periods ended December 31, 2005 and January 1, 2005, respectively.

Total assets of discontinued operations totaled \$6.1 million at March 26, 2005 and \$6.2 million at December 31, 2005. Total liabilities of discontinued operations decreased from \$14.4 million at March 26, 2005 to \$12.5 million at December 31, 2005.

Spartan Stores anticipates that it will be subject to a partial withdrawal liability from a multi-employer pension plan related to the 2003 closures of certain of its discontinued *Food Town* stores when a final determination is made after June 30, 2006. Recent estimates provided by the trustees of the multi-employer pension plan indicate that there will be an underfunded liability which we believe to have resulted from a change in actuarial assumptions, investment

performance, other employers' withdrawals, or a combination of these factors, occurring subsequent to the closure of these stores. Spartan Stores intends to challenge such a determination prior to settling the partial withdrawal liability when assessed after June 2006. Spartan Stores has estimated its liability based on available preliminary information and recorded an after-tax charge of approximately \$1.1 million in Discontinued Operations in the third quarter of fiscal 2006.

Note 6**Asset Impairments and Exit Costs**

The Grocery Distribution segment recognized an asset impairment charge of \$0.3 million in the third quarter related to banana ripening equipment that is being replaced. We are in the process of upgrading this equipment to the latest technology as well as expanding our produce storage facility in anticipation of higher incremental produce sales volumes from new customers and expanded contracts with existing customers.

The Retail segment recognized charges of \$0.2 million in the second quarter of fiscal 2006 for lease and related ancillary costs related to the closure of two Pharm stores. In the third quarter of fiscal 2006, a charge of \$0.5 million was incurred due to changes in real estate market conditions and resulting estimated sublease income for closed stores.

The following table provides the activity of exit costs for the 40 weeks ended December 31, 2005. Exit costs recorded in the Consolidated Balance Sheets are included in Other accrued expenses in current liabilities and Other long-term liabilities based on when the obligations are expected to be paid.

(In thousands)

| | Lease and Ancillary Costs |
|---|------------------------------|
| | <hr/> |
| Balance at March 27, 2005 | \$ 15,520 |
| Provision for lease and related ancillary costs, net of estimated sublease recoveries | 639 |
| Provision for pension withdrawal liability | 1,654(a) |
| Payments, net of interest accretion | (3,292) |
| | <hr/> |
| Balance at December 31, 2005 | \$ 14,521 |
| | <hr/> |

(a) Represents a pension withdrawal liability from a multi-employer pension plan affiliated with the former discontinued Food Town supermarkets. Charge was recorded in discontinued operations. (See Note 5)

Note 7**Associate Retirement Plans**

The following table provides the components of net periodic pension and postretirement benefit costs for the third quarter and year-to-date periods ended December 31, 2005 and January 1, 2005:

(In thousands)

| 16 Weeks Ended | Pension Benefits | | SERP Benefits | | Postretirement Benefits | |
|--------------------------------|------------------|-----------------|------------------|-----------------|-------------------------|-----------------|
| | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Jan. 1, 2005 |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |
| Service cost | \$ 753 | \$ 798 | \$ 4 | \$ 5 | \$ 54 | \$ 57 |
| Interest cost | 577 | 651 | 8 | 9 | 96 | 97 |
| Expected return on plan assets | (723) | (859) | - | - | - | - |
| Net amortization and deferral | (98) | (137) | 4 | 3 | (6) | (7) |
| | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> | <hr/> |

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| | | | | | | |
|--------------------------------|-------------------------|-----------------|----------------------|-----------------|--------------------------------|-----------------|
| Net periodic benefit cost | \$ 509 | \$ 453 | \$ 16 | \$ 17 | \$ 144 | \$ 147 |
| (In thousands) | | | | | | |
| 40 Weeks Ended | Pension Benefits | | SERP Benefits | | Postretirement Benefits | |
| | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Jan. 1, 2005 |
| Service cost | \$ 2,259 | \$ 2,642 | \$ 12 | \$ 15 | \$ 161 | \$ 171 |
| Interest cost | 1,730 | 1,953 | 23 | 26 | 287 | 291 |
| Expected return on plan assets | (2,169) | (2,577) | - | - | - | - |
| Net amortization and deferral | (293) | (411) | 12 | 9 | (15) | (21) |
| Net periodic benefit cost | \$ 1,527 | \$ 1,607 | \$ 47 | \$ 50 | \$ 433 | \$ 441 |

Spartan Stores expects to contribute \$3.2 million to its defined benefit plans in fiscal 2006 to meet the minimum funding requirements. As of December 31, 2005, \$2.8 million has been contributed. In fiscal 2005, Spartan Stores contributed \$0.8 million to its defined benefit plans.

Note 8 Supplemental Cash Flow Information

Non-cash financing activities include the issuance of restricted stock to employees and directors of \$3.1 million for the year-to-date period ended December 31, 2005 of which \$0.4 million has been amortized to compensation expense. The remaining balance of \$2.7 million is included in deferred stock-based compensation in the Statement of Shareholders' Equity and will be amortized to expense over the vesting term.

Note 9 Operating Segment Information

The following tables set forth information about Spartan Stores by operating segment:

(In thousands)

| | Grocery Distribution | Retail | Total |
|---|-------------------------|-------------------|--------------|
| 16 Weeks Ended December 31, 2005 | | | |
| Net sales | \$ 375,023 | \$ 267,251 | \$ 642,274 |
| Depreciation and amortization | 2,420 | 3,519 | 5,939 |
| Operating earnings | 7,249 | 1,116 | 8,365 |
| Capital expenditures | 1,318 | 6,506 | 7,824 |
| 16 Weeks Ended January 1, 2005 | | | |
| Net sales | \$ 346,532 | \$ 277,985 | \$ 624,517 |
| Depreciation and amortization | 2,426 | 3,745 | 6,171 |
| Operating earnings | 6,857 | 4,583 | 11,440 |
| Capital expenditures | 2,560 | 7,001 | 9,561 |
| 40 Weeks Ended December 31, 2005 | | | |
| Net sales | \$ 895,410 | \$ 691,725 | \$ 1,587,135 |
| Depreciation and amortization | 6,334 | 9,074 | 15,408 |
| Operating earnings | 16,425 | 10,181 | 26,606 |
| Capital expenditures | 5,650 | 11,325 | 16,975 |
| 40 Weeks Ended January 1, 2005 | | | |
| Net sales | \$ 861,858 | \$ 723,685 | \$ 1,585,543 |
| Depreciation and amortization | 6,302 | 9,802 | 16,104 |
| Operating earnings | 18,040 | 11,523 | 29,563 |
| Capital expenditures | 5,844 | 11,927 | 17,771 |
| | December 31, 2005 | March 26, 2005 | |
| Total assets | | | |
| Grocery Distribution | \$ 186,687 | \$ 191,086 | |
| Retail | 185,962 | 187,301 | |

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| | | |
|-------------------------|------------|------------|
| Discontinued operations | 6,223 | 6,070 |
| | <hr/> | <hr/> |
| Total | \$ 378,872 | \$ 384,457 |
| | <hr/> | <hr/> |

Note 10

Acquisition of Assets

On December 17, 2005, Spartan Stores entered into an Asset Purchase Agreement (the "Purchase Agreement") with D&W Food Centers, Inc. and D&W Associate Resources, LLC (together "D&W"), to acquire certain operating assets of D&W, a privately held Grand Rapids, Michigan-based retail grocery operator with 20 retail stores located in West Michigan. Under the terms of the Purchase Agreement, Spartan Stores would acquire and assume D&W's leases at 20 stores, leasehold improvements and certain operating assets associated with those stores, D&W trademarks, trade names and intangibles, and certain other property for a purchase price of \$45 million in cash. Spartan Stores would also purchase a limited amount of inventory.

Spartan Stores intends to finance this acquisition with borrowings on its senior secured revolving credit facility and expects the transaction to be completed late in its fiscal 2006 fourth quarter or early in its fiscal 2007 first quarter. The closing of the transaction is subject to a number of conditions stated in the Purchase Agreement. These conditions include, among others, that Spartan Stores be satisfied with its due diligence investigation; that certain consents, waivers, approvals, agreements, and certificates be obtained from landlords and a variety of other third parties affected by the transaction; and that required regulatory approvals be obtained. The Purchase Agreement also contains representations and warranties of both parties, indemnification agreements, termination rights, and a variety of covenants and agreements.

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

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

We currently operate two reportable business segments: Grocery Distribution and Retail. Our Grocery Distribution segment provides a full line of grocery, general merchandise, frozen and perishable items to over 350 independently owned grocery stores and our 73 corporate owned stores. Our Retail segment operates 54 retail supermarkets in Michigan under the banners *Family Fare Supermarkets* and *Glen's Markets*, 19 deep-discount food and drug stores in Ohio and Michigan under the banner *The Pharm*, and 5 fuel centers under the banners *Family Fare Quick Stop* and *Glen's Quick Stop*. Our retail supermarkets have a "neighborhood market" focus to distinguish them from supercenters and limited assortment stores. Our deep-discount food and drug stores offer a unique combination of full-service pharmacy, general merchandise products and basic food offerings.

Our sales and operating performance vary with seasonality. Our first and fourth quarters are typically our slowest sales quarters and therefore operating results are generally lower during these two quarters. Additionally, these two quarters can be affected based on the timing of the Easter holiday, which is a strong sales week. All quarters are 12 weeks, except for our third quarter, which is 16 weeks and includes the Thanksgiving and Christmas holidays. Most of our northern Michigan stores are dependent on tourism and, therefore, most affected by seasons and weather patterns, including, but not limited to, the temperature and rainfall during the summer months and to a lesser extent snowfall during the winter months.

On December 17, 2005, we entered into an Asset Purchase Agreement (the "Purchase Agreement") with D&W Food Centers, Inc. and D&W Associate Resources, LLC (together "D&W"), to acquire certain operating assets of D&W, a privately held Grand Rapids, Michigan-based retail grocery operator with 20 retail stores located in West Michigan. Under the terms of the Purchase Agreement, we would acquire and assume D&W's leases at 20 stores, leasehold improvements and certain operating assets associated with those stores, D&W trademarks, trade names and intangibles, and certain other property for a purchase price of \$45 million in cash. We would also purchase a limited amount of inventory.

We intend to finance this acquisition with borrowings on our senior secured revolving credit facility and expect the transaction to be completed late in our fiscal 2006 fourth quarter or early in our fiscal 2007 first quarter. The closing of the transaction is subject to a number of conditions stated in the Purchase Agreement. These conditions include, among others, that we be satisfied with our due diligence investigation; that certain consents, waivers, approvals, agreements, and certificates be obtained from landlords and a variety of other third parties affected by the transaction; and that required regulatory approvals be obtained. The Purchase Agreement also contains representations and warranties of both parties, indemnification agreements, termination rights, and a variety of covenants and agreements.

Results of Operations

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

(Unaudited)

| | Percentage of Net Sales | | | | Percentage Change | |
|--|-------------------------|-----------------|------------------|-----------------|-------------------|------------------|
| | 16 Weeks Ended | | 40 Weeks Ended | | 16 Weeks Ended | 40 Weeks Ended |
| | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Jan. 1, 2005 | Dec. 31, 2005 | Dec. 31, 2005 |
| Net sales | 100.0 | 100.0 | 100.0 | 100.0 | 2.8 | 0.1 |
| Gross margin | 18.0 | 18.8 | 18.6 | 18.8 | (1.4) | (1.1) |
| Selling, general and administrative | 16.6 | 17.0 | 16.8 | 17.0 | .6 | (0.5) |
| Provision for asset impairments and exit costs | 0.1 | 0.0 | 0.1 | 0.0 | | |
| Operating earnings | 1.3 | 1.8 | 1.7 | 1.8 | (26.9) | (10.0) |
| Other income and expenses | 0.2 | 0.3 | 0.3 | 0.4 | (36.5) | (28.0) |
| Debt extinguishment | 0.0 | 0.1 | 0.0 | 0.0 | (100.0) | (100.0) |
| Earnings before income taxes and discontinued operations | 1.1 | 1.4 | 1.4 | 1.4 | (20.2) | (2.5) |
| Income taxes | 0.4 | 0.5 | 0.5 | 0.5 | (24.7) | (7.9) |
| Earnings from continuing operations | 0.7 | 0.9 | 0.9 | 0.9 | (17.7) | 0.4 |
| Loss from discontinued operations | (0.2) | (0.2) | (0.1) | (0.1) | 11.0 | 14.7 |
| Net earnings | 0.5 | 0.7 | 0.8 | 0.8 | (25.8) | (1.3) |

Net Sales - Net sales for the quarter ended December 31, 2005 ("third quarter") increased \$17.8 million, or 2.8 percent, from \$624.5 million in the quarter ended January 1, 2005 ("prior year third quarter") to \$642.3 million. Net sales for the year-to-date period ended December 31, 2005 ("current year-to-date") increased \$1.6 million, or 0.1 percent, from \$1,585.5 million in the prior year-to-date period ended January 1, 2005 ("prior year-to-date") to \$1,587.1 million.

Net sales for the third quarter in our Grocery Distribution segment increased \$28.5 million, or 8.2 percent, from \$346.5 million in the prior year third quarter to \$375.0 million. Net sales for the current year-to-date period increased \$33.6 million, or 3.9 percent, from \$861.9 million in the prior year-to-date period to \$895.4 million. The sales increases were primarily due to the previously announced addition of new distribution customers to the segment's sales base (\$6.4 million for the third quarter and \$11.9 million year-to-date) and an increase in sales to existing customers and strong holiday sales. Sales increases for the year-to-date period were partially offset by the previously disclosed transition of two customers to new suppliers (\$5.9 million).

Net sales for the third quarter in our Retail segment decreased \$10.7 million, or 3.9 percent, from \$278.0 million in the prior year third quarter to \$267.3 million. Net sales for the year-to-date period decreased \$32.0 million, or 4.4

percent, from \$723.7 million in the prior year-to-date period to \$691.7 million. Sales decreases were due primarily to the closing of two underperforming Pharm stores (\$4.2 million for the third quarter and \$9.0 million year-to-date), supercenter competition, and sale of a retail store joint venture (\$5.6 million for the third quarter and \$15.2 million year-to-date). The sales decline was partially offset by higher incremental sales from the Company's fuel centers (\$2.0 million for the third quarter and \$4.6 million year-to-date).

Comparable store sales at supermarkets declined 1.3 percent during the third quarter, while comparable store sales at our Pharm deep-discount food and drug stores increased 0.4 percent. Total retail comparable store sales declined 1.0 percent in the third quarter, including sales from five fuel centers, which contributed a positive 1.4 percent. For the current year-to-date period, comparable store sales at supermarkets declined 1.8 percent, while comparable store sales at our Pharm deep-discount food and drug stores declined 2.0 percent. Total retail

comparable store sales declined 1.9 percent during the current year-to-date period, while fuel center sales contributed a positive 1.2 percent to the total.

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

Gross margin for the third quarter decreased \$1.6 million, or 1.4 percent, from \$117.4 million in the prior year third quarter to \$115.7 million. As a percent of net sales, gross margin for the third quarter decreased to 18.0 percent from 18.8 percent. Gross margin for the year-to-date period decreased \$3.2 million, or 1.1 percent, from \$298.3 million in the prior year-to-date period to \$295.1 million. As a percent of net sales, gross margin for the year-to-date period decreased to 18.6 percent from 18.8 percent. The decline in gross margin for the third quarter and year-to-date periods was primarily due to a favorable supplier contract settlement of \$2.2 million recorded in last year's third quarter and a greater percentage of consolidated sales contribution from the lower-margin Grocery Distribution segment and fuel sales in the current year. A greater percentage of Grocery Distribution segment sales decreased consolidated gross margin by 29 basis points for the third quarter and 20 basis points year-to-date.

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

SG&A expenses for the third quarter increased \$.7 million, or .6 percent, from \$105.9 million in the prior year third quarter to \$106.6 million. As a percent of net sales, SG&A expenses were 16.6 percent for the current quarter compared to 17.0 percent in the prior year third quarter. SG&A expenses for the year-to-date period decreased \$1.3 million, or 0.5 percent, from \$268.8 million in the prior year-to-date period to \$267.4 million. As a percent of net sales, SG&A expenses were 16.8 percent year-to-date versus 17.0 percent for the prior year-to-date period.

The dollar increase in SG&A for the third quarter was due to the following:

- Increased compensation and benefits of \$1.7 million due to increases in sales volume at the Grocery Distribution segment
- Increased utilities expense of \$1.1 million
- Additional legal and professional fees associated with the conclusion of the review of strategic alternatives and a contract dispute resolution of \$0.5 million
- Increased fuel costs of \$0.4 million
- The prior year included a favorable adjustment of \$0.7 million to the allowance for bad debts due to improved credit collection trends
- The costs of operating additional fuel centers of \$0.3 million

These increases were partially offset by the following:

- The sale of a single store joint venture in the prior year which had SG&A expenses of \$1.6 million
- Closure of two Pharm stores which decreased SG&A by \$1.0 million
- Decreased store labor due to productivity improvements of \$1.0 million
- A \$0.6 million favorable Michigan Single Business Tax adjustment due to a closed audit

On a year-to-date basis, the decrease in SG&A is due to the following:

- The sale of a single store joint venture in the prior year which had SG&A expenses of \$4.2 million
- The closure of two Pharm stores which decreased SG&A by \$1.6 million
- Reduced store labor of \$3.0 million due to productivity improvements

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The Michigan Single Business Tax adjustment previously mentioned of \$0.6 million

These decreases were substantially offset by the following:

- Increases in other compensation and benefits of \$2.2 million due to increases in sales volume at the Grocery Distribution segment
- The termination and penalty payments received in the prior year from a former Grocery Distribution customer of \$1.3 million
- Increased utilities expense of \$1.6 million
- Legal and professional fees associated with the conclusion of the review of strategic alternatives and a contract dispute resolution of \$1.4 million
- The costs of operating additional fuel centers of \$0.8 million
- Increased fuel costs of \$0.8 million
- The prior year included a favorable adjustment of \$0.7 million to the allowance for bad debts due to improved credit collection trends

Provision for Asset Impairments and Exit Costs - Asset impairments and exit costs were \$0.8 million for the third quarter and \$1.1 million for the year-to-date period. In the third quarter, an asset impairment charge of \$0.3 million was incurred related to banana ripening equipment that is being replaced. We are in the process of upgrading this equipment to the latest technology as well as expanding our produce storage facility in anticipation of higher incremental produce sales volumes from new customers and expanded contracts with existing customers. We also increased the exit cost reserve \$0.5 million due to changes in real estate market conditions and resulting estimated sublease income. The year-to-date amount also includes charges related to the closure of two Pharm stores.

Interest Expense - Interest expense for the third quarter decreased \$0.4 million, or 12.4 percent, from \$2.9 million in the prior year third quarter to \$2.5 million. Interest expense for the year-to-date period decreased \$1.4 million, or 18.7 percent, from \$7.5 million in the prior year-to-date period to \$6.1 million. The decrease in interest expense is primarily due to lower total average borrowings partially offset with market driven rate increases. Total average borrowings decreased \$28.2 million from \$112.1 million in the prior year to \$83.9 million as a result of debt repayments resulting primarily from cash flow from operations.

Debt Extinguishment - We recorded a \$0.6 million non-cash charge for the write-off of unamortized financing fees during the prior year third quarter as result of refinancing activities.

Other, net - Other, net for the third quarter and year-to-date period increased \$0.4 million, from \$0.9 million in the prior year third quarter to \$1.3 million. Other, net for the third quarter and year-to-date period includes a gain on the sale of land of \$1.4 million. Other, net for the prior year third quarter and prior year-to-date period includes a gain of \$0.8 million on the sale of a single store joint venture.

Income Taxes - The effective tax rate for the third quarter and year-to-date periods ended December 31, 2005 is 33.0%. The slightly lower rate is due primarily to permanent tax deductions for restricted stock expense being greater than the related expense recorded in the consolidated financial statements.

Discontinued Operations

Our former convenience distribution operations, insurance operations and certain of our retail, grocery distribution and real estate operations have been recorded as discontinued operations. Results of the discontinued operations are excluded from the accompanying notes to the condensed consolidated financial statements for all periods presented, unless otherwise noted.

Discontinued operations had no sales during the third quarter and year-to-date periods ended December 31, 2005 and January 1, 2005. The operating losses in discontinued operations for the third quarters ended December 31,

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2005 and January 1, 2005 of \$2.1 million and \$2.0 million were partially offset by income tax benefits of \$0.7 million and \$0.7 million for the third quarters ended December 31, 2005 and January 1, 2005, respectively. The operating losses in discontinued operations for the year-to-date periods ended December 31, 2005 and January 1,

2005 of \$2.7 million and \$2.4 million were partially offset by income tax benefits of \$0.9 million and \$0.8 million for the year-to-date periods ended December 31, 2005 and January 1, 2005, respectively.

Total assets of discontinued operations were \$6.1 million at March 26, 2005 and \$6.2 million at December 31, 2005. Total liabilities of discontinued operations decreased from \$14.4 million at March 26, 2005 to \$12.5 million at December 31, 2005.

We anticipate that we will be subject to a partial withdrawal liability from a multi-employer pension plan related to the 2003 closures of certain of our discontinued *Food Town* stores when a final determination is made after June 30, 2006. Recent estimates provided by the trustees of the multi-employer pension plan indicate that there will be an underfunded liability which we believe to have resulted from a change in actuarial assumptions, investment performance, other employers' withdrawals, or a combination of these factors, occurring subsequent to the closure of these stores. We intend to challenge such a determination prior to settling the partial withdrawal liability when assessed after June 2006. Spartan Stores has estimated its liability based on available preliminary information and recorded an after-tax charge of approximately \$1.1 million in Discontinued Operations in the third quarter of fiscal 2006.

Liquidity and Capital Resources

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

(In thousands)

| | December 31, 2005 | January 1, 2005 |
|--|------------------------------|----------------------------|
| Net cash provided by operating activities | \$ 33,174 | \$ 47,405 |
| Net cash used in investing activities | (14,765) | (15,144) |
| Net cash used in financing activities | (17,540) | (26,896) |
| Net cash used in discontinued operations | (3,967) | (4,041) |
| Net (decrease) increase in cash and cash equivalents | (3,098) | 1,324 |
| Cash and cash equivalents at beginning of year | 14,880 | 13,252 |
| Cash and cash equivalents at end of period | \$ 11,782 | \$ 14,576 |

Net cash provided by operating activities decreased from the prior year-to-date period primarily due to an increase in inventory due primarily to additional private label and specialty product offerings, the timing of certain winter promotional programs and incremental pharmacy and fuel inventories, a vendor contract settlement received in the prior year, pension contributions, and payment of incentive compensation related to fiscal 2005 performance.

As of December 31, 2005, we have available a Federal income tax net operating loss carryforward of approximately \$24.3 million. As a result, no regular Federal income taxes have been paid in Fiscal 2006, however, we do anticipate paying approximately \$.2 million in Alternative Minimum Tax in Fiscal 2006. No Federal income taxes were paid in Fiscal 2005.

Net cash used in investing activities decreased during the current fiscal year primarily due to decreased capital expenditure activity. Our Grocery Distribution and Retail segments utilized 33% and 67%, respectively, of our capital

expenditure dollars. Expenditures were used for new equipment, software and store remodels and refurbishments. Under the terms of our credit facility, should our available borrowings fall below certain levels, our capital expenditures would be restricted each fiscal year. We expect capital expenditures to range from \$25.0 million to \$28.0 million for fiscal 2006, which would be below the restriction.

Net cash used in financing activities includes cash paid and received from our long-term borrowings. Our current maturities of long-term debt at December 31, 2005 are \$1.7 million. Our ability to borrow additional funds is governed by the terms of our credit facilities.

Net cash used in discontinued operations contains the net cash flows of our discontinued operations and consists primarily of the payment of store exit cost reserves and long-term debt. We expect the cash usage of our discontinued operations will be approximately \$7.2 million to \$8.2 million in fiscal 2006 for the payment of store exit costs, insurance runoff claims and other liabilities.

Our principal sources of liquidity are cash flows generated from operations and our amended \$225.0 million credit facility. The credit facility matures December 2010, and is secured by substantially all of our assets. As of December 31, 2005, we had outstanding borrowings of \$66.1 million on our credit facility. We had available borrowings of \$107.8 million at December 31, 2005 and maximum availability of \$117.8 million, which exceeds the minimum excess availability levels, as defined in the credit agreement. Also in December 2005, as permitted by amendment to our senior secured revolving credit facility, our board of directors approved a change to our dividend policy. Under the new policy, we expect to begin paying a quarterly cash dividend of \$0.05 per common share beginning in our fiscal 2006 fourth quarter. We believe that cash generated from operating activities and available borrowings under the credit facility are sufficient to support current operations, payment of cash dividends and the pending D&W acquisition.

Our current ratio was 1.21:1.00 at December 31, 2005 and March 26, 2005 and our investment in working capital was \$29.4 million at December 31, 2005 versus \$30.3 million at March 26, 2005. Our debt to total capital ratio at December 31, 2005 was .36:1.00 versus .43:1.00 at March 26, 2005 primarily due to reducing debt by \$18.3 million and the year-to-date net earnings of \$12.9 million.

For information on contractual obligations, see our Annual Report on Form 10-K for the fiscal year ended March 26, 2005. At December 31, 2005, there have been no material changes to our significant contractual obligations outside the ordinary course of business other than the amendment of our senior secured revolving credit facility and entry into the Asset Purchase Agreement with D&W.

At December 31, 2005 long-term debt was due as follows:

(In thousands)

| Fiscal Year | |
|-------------|-----------|
| 2006 | \$ 450 |
| 2007 | 2,135 |
| 2008 | 4,135 |
| 2009 | 591 |
| 2010 | 66,707 |
| Thereafter | 2,503 |
| | \$ 76,521 |

New Accounting Standards

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123(R), "Share-Based Payment" that will require compensation costs related to share-based payment transactions to be recognized in the consolidated financial statements. With limited exceptions, the amount of compensation cost will be measured based on the grant date fair value of the equity or liability instruments issued. In addition, liability awards will be remeasured each reporting period. Compensation cost will be recognized over the period that an employee provides services in exchange for the award. SFAS No. 123(R) replaces SFAS No. 123, and supercedes APB Opinion

No. 25. This Statement becomes effective for Spartan Stores at the beginning of fiscal 2007.

We intend to adopt SFAS No. 123(R) using the "modified prospective" transition method beginning with the first quarter of fiscal 2007. Under this method, awards that are modified, granted, or settled on or after March 26, 2006 will be measured and accounted for in accordance with SFAS No. 123(R). In addition, in our first quarter of fiscal 2007, expense must be recognized for unvested awards that were granted prior to our adoption of SFAS No. 123(R), and the expense will be based on the fair value determined at the grant date under SFAS No. 123,

"Accounting for Stock-Based Compensation." As permitted by SFAS No. 123, we currently account for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, recognize no compensation cost for employee stock options. The impact of adoption of SFAS No. 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. Had we adopted SFAS No. 123(R) in prior periods, the impact of that standard would have approximated the impact of SFAS No. 123 as described in the disclosure of pro forma net income and earnings per share in Note 1 to our consolidated financial statements. However, the calculation of compensation cost for share-based payment transactions after the effective date of SFAS No. 123(R) may be different from the calculation of compensation cost under SFAS No. 123, and such differences have not yet been quantified.

In June 2005, the Emerging Issues Task Force ("EITF") reached a consensus on EITF Issue No. 05-6, "Determining the Amortization Period for Leasehold Improvements Purchased after Lease Inception or Acquired in a Business Combination" ("EITF 05-6"). EITF 05-6 requires that leasehold improvements acquired in a business combination be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date of acquisition. EITF 05-6 also requires that leasehold improvements that are placed in service significantly after and not contemplated at or near the beginning of the lease term be amortized over the shorter of the useful life of the assets or a term that includes required lease periods and renewals that are deemed to be reasonably assured at the date the leasehold improvements are purchased. EITF 05-6 became effective for our fiscal quarter beginning September 11, 2005. The impact of EITF 05-6 did not have a material effect on our consolidated financial statements.

In October 2005, the FASB issued FASB Staff Position FAS 13-1, "Accounting for Rental Costs Incurred During a Construction Period" ("FSP FAS 13-1"). FSP FAS 13-1 requires rental costs associated with building or ground leases incurred during a construction period to be recognized as rental expense. FSP FAS 13-1 is effective for the first reporting period beginning after December 15, 2005; however, a lessee is required to cease capitalizing rental costs as of December 15, 2005 for operating lease arrangements entered into prior to December 15, 2005. Early adoption is permitted for annual or interim financial statements that have not yet been issued. We will adopt FSP FAS 13-1 beginning with the fiscal fourth quarter beginning January 1, 2006. The impact of FSP FAS 13-1 is not expected to have a material effect on our consolidated financial statements.

Critical Accounting Policies

This discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts. On an ongoing basis, we evaluate our estimates, including those related to bad debts, inventories, intangible assets, assets held for sale, long-lived assets, income taxes, self-insurance reserves, exit costs, retirement benefits and contingencies and litigation. We base our estimates on historical experience and on various other assumptions and factors that we believe to be reasonable under the circumstances. Based on our ongoing review, we make adjustments we consider appropriate under the facts and circumstances. We have discussed the development, selection and disclosure of these estimates with the Audit Committee. The accompanying condensed consolidated financial statements are prepared using the same critical accounting policies discussed in our Annual Report on Form 10-K for the fiscal year ended March 26, 2005.

ITEM 3. Quantitative and Qualitative Disclosure About Market Risk

There have been no material changes in market risk of Spartan Stores from the end of its preceding fiscal year to the date of the interim consolidated balance sheet in this filing.

ITEM 4. Controls and Procedures

An evaluation of the effectiveness of the design and operation of Spartan Stores' disclosure controls and procedures (as currently defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) was performed as of

December 31, 2005 (the "Evaluation Date"). This evaluation was performed under the supervision and with the participation of Spartan Stores' management, including its Chief Executive Officer ("CEO") and Chief Financial

Officer ("CFO"). As of the Evaluation Date, Spartan Stores' management, including the CEO and CFO, concluded that Spartan Stores' disclosure controls and procedures were effectively designed and operated to cause material information relating to Spartan Stores (including its consolidated subsidiaries) required to be included in Spartan Stores' periodic filings with the Securities and Exchange Commission to be accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. During the last fiscal quarter there was no change in Spartan Stores' internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, Spartan Stores' internal control over financial reporting.

PART II
OTHER INFORMATION

ITEM 6. Exhibits

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

| <u>Exhibit Number</u> | <u>Document</u> |
|-----------------------|--|
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| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

SIGNATURES

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

SPARTAN STORES, INC.
(Registrant)

Date: February 3, 2006

By

/s/ David M. Staples

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

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