

Blue Buffalo Pet Products, Inc.
Form 10-Q
November 14, 2016

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
x FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2016

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:

001 - 37510

BLUE BUFFALO PET PRODUCTS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware 46-0552933
(State or Other Jurisdiction of (I.R.S. Employer Identification No.)
Incorporation or Organization)

11 River Road
Wilton, Connecticut 06897
(Address of Principal Executive Offices, Including Zip Code)
(203) 762-9751
(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 (X) No ()

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate website, 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 (X) No ()

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

Large Accelerated Filer () Accelerated Filer ()
Non-Accelerated Filer (X) Smaller Reporting Company ()

(Do not check if a smaller reporting company)

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

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

Common Stock

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	Outstanding Shares at November 10, 2016
Common stock, par value \$0.01 per share	196,515,280

Blue Buffalo Pet Products, Inc.
Index

<u>Part I. Financial Information</u>		Page
<u>Item 1.</u>	<u>Financial Statements</u>	
	<u>Unaudited Condensed Consolidated Balance Sheets as of September 30, 2016 and December 31, 2015</u>	<u>1</u>
	<u>Unaudited Condensed Consolidated Statements of Income for the three and nine months ended September 30, 2016 and 2015</u>	<u>2</u>
	<u>Unaudited Condensed Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2016 and 2015</u>	<u>3</u>
	<u>Unaudited Condensed Consolidated Statement of Changes in Stockholders' Equity (Deficit) for the nine months ended September 30, 2016</u>	<u>4</u>
	<u>Unaudited Condensed Consolidated Statements of Cash Flows for the nine months ended September 30, 2016 and 2015</u>	<u>5</u>
	<u>Notes to the Unaudited Condensed Consolidated Financial Statements</u>	<u>6</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>18</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>27</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>	<u>27</u>
 <u>Part II. Other Information</u>		
<u>Item 1.</u>	<u>Legal Proceedings</u>	<u>29</u>
<u>Item 1A.</u>	<u>Risk Factors</u>	<u>32</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>32</u>
<u>Item 3.</u>	<u>Defaults upon Senior Securities</u>	<u>32</u>
<u>Item 4.</u>	<u>Mine Safety Disclosures</u>	<u>32</u>
<u>Item 5.</u>	<u>Other Information</u>	<u>32</u>
<u>Item 6.</u>	<u>Exhibits</u>	<u>33</u>
 <u>Signatures</u>		 <u>34</u>

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

In addition to historical information, this Quarterly Report on Form 10-Q may contain “forward-looking statements” within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), which are subject to the “safe harbor” created by those sections. All statements, other than statements of historical facts included in this Form 10-Q, including statements concerning our plans, objectives, goals, beliefs, business strategies, future events, business conditions, results of operations, financial position, business outlook, business trends and other information, may be forward-looking statements. Words such as “anticipate,” “assume,” “believe,” “continue,” “could,” “estimate,” “expect,” “inter,” “plan,” “potential,” “predict,” “project,” “future,” “will,” “seek,” “foreseeable” and variations of such words or similar expressions are intended to identify forward-looking statements. The forward-looking statements are not historical facts, and are based upon our current expectations, beliefs, estimates and projections, and various assumptions, many of which, by their nature, are inherently uncertain and beyond our control. Our expectations, beliefs, estimates and projections are expressed in good faith and we believe there is a reasonable basis for them. However, there can be no assurance that management’s expectations, beliefs, estimates and projections will result or be achieved and actual results may vary materially from what is expressed in or indicated by the forward-looking statements.

There are a number of risks, uncertainties and other important factors, many of which are beyond our control, that could cause our actual results to differ materially from the forward-looking statements contained in this Form 10-Q. Such risks, uncertainties and other important factors that could cause actual results to differ include, among others, the risks, uncertainties and factors set forth under “Risk Factors” in the Company’s final prospectus for its secondary public offering, as filed with the Securities and Exchange Commission (the “SEC”) on September 14, 2016, as such risk factors may be updated from time to time in our periodic filings with the SEC, and which are accessible on the SEC’s website at www.sec.gov, including the following:

• We may not be able to successfully implement our growth strategy on a timely basis or at all;

• The growth of our business depends on our ability to accurately predict consumer trends and demand and successfully introduce new products and product line extensions and improve existing products;

• Any damage to our reputation or our brand could have a material adverse effect on our business, financial condition, and results of operations;

• Our growth and business are dependent on trends that may change or not continue, and our historical growth may not be indicative of our future growth;

• There may be decreased spending on pets in a challenging economic climate;

• Our business depends, in part, on the sufficiency and effectiveness of our marketing and trade promotion programs;

• If we are unable to maintain or increase prices, our margins may decrease;

• We are dependent on a relatively limited number of customers for a significant portion of our sales;

• We rely upon a limited number of contract manufacturers to provide a significant portion of our supply of products; and

We caution you that the risks, uncertainties and other factors referenced above may not contain all of the risks, uncertainties and other factors that are important to you. In addition, we cannot assure you that we will realize the results, benefits or developments that we expect or anticipate or, even if substantially realized, that they will result in the consequences or affect us or our business in the way expected. There can be no assurance that (i) we have correctly measured or identified all of the factors affecting our business or the extent of these factors' likely impact, (ii) the available information with respect to these factors on which such analysis is based is complete or accurate, (iii) such analysis is correct or (iv) our strategy, which is based in part on this analysis, will be successful. All forward-looking statements in this report apply only as of the date of this report or as of the date they were made and, except as required by applicable law, we undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future developments or otherwise.

We use the terms "we," "us" and the "Company" in this Quarterly Report on Form 10-Q to refer to Blue Buffalo Pet Products, Inc. and its subsidiaries. We use the term "Wholesome Natural" in this Quarterly Report on Form 10-Q to refer to the pet food market consisting of brands that achieve their nutritional targets using only natural ingredients (as defined by the Association of American Feed Control Officials), which may include added vitamins, minerals and other trace nutrients. All Wholesome Natural dry foods have whole meats and/or meat meals, with the type of animal protein clearly identified, as their principal ingredients. Wholesome Natural products (dry foods, wet foods and treats) do not include chicken or poultry by-product meals, which we believe pet parents do not desire. Wholesome Natural products also do not rely on grain proteins, such as corn gluten meal, wheat gluten and soybean meal, as principal sources of protein, as grain proteins have a narrower array of amino acids compared to animal proteins. In addition, these products also do not use corn, wheat, soy or fractionated grains, such as brewer's rice, as sources of starch. For more information regarding our definitions of market segments, see the description set forth under the "Terms Used in This Annual Report on Form 10-K" and "Item 1. Business" sections of our Annual Report on Form 10-K.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

Blue Buffalo Pet Products, Inc.

Unaudited Condensed Consolidated Balance Sheets

(dollars in thousands, except for share data)

	September 30, 2016	December 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 316,362	\$ 224,253
Receivables, net	92,398	80,103
Inventories	75,400	83,482
Prepaid expenses and other current assets	6,515	4,492
Total current assets	490,675	392,330
Restricted cash	781	473
Property, plant and equipment, net	126,282	115,160
Deferred income taxes	1,696	3,907
Deferred debt issuance costs, net	104	196
Other assets	517	480
Total assets	\$ 620,055	\$ 512,546
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Current maturities of long-term debt	\$ 3,960	\$ 3,960
Accounts payable	35,478	31,428
Other current liabilities	72,394	70,459
Total current liabilities	111,832	105,847
Long-term debt	380,167	383,137
Deferred income taxes	4,117	3,268
Other long-term liabilities	14,291	11,013
Total liabilities	510,407	503,265
Commitments and contingencies		
Stockholders' equity (deficit):		
Preferred stock; \$0.01 par value; 150,000,000 shares authorized; none issued or outstanding at September 30, 2016 and December 31, 2015	—	—
Common stock, voting; \$0.01 par value; 1,500,000,000 shares authorized; 196,515,280 and 196,216,596 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	1,965	1,962
Additional paid-in capital	69,752	64,899
Retained earnings (accumulated deficit)	37,890	(57,549)
Accumulated other comprehensive income (loss)	41	(31)
Total stockholders' equity	109,648	9,281
Total liabilities and stockholders' equity	\$ 620,055	\$ 512,546

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

1

Blue Buffalo Pet Products, Inc.

Unaudited Condensed Consolidated Statements of Income

(dollars in thousands, except for share data)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net sales	\$287,996	\$ 259,437	\$854,682	\$ 762,209
Cost of sales	154,787	151,152	470,938	454,595
Gross profit	133,209	108,285	383,744	307,614
Selling, general and administrative expenses	65,493	58,664	190,849	165,723
Provision for legal settlement	32,000	—	32,000	—
Operating income	35,716	49,621	160,895	141,891
Interest expense, net	3,629	3,722	10,872	11,097
Income before income taxes	32,087	45,899	150,023	130,794
Provision for income taxes	10,605	18,833	54,584	51,044
Net income	\$21,482	\$ 27,066	\$95,439	\$ 79,750
Basic net income per common share	\$0.11	\$ 0.14	\$0.49	\$ 0.41
Diluted net income per common share	\$0.11	\$ 0.14	\$0.48	\$ 0.40
Basic weighted average shares	196,445,684	196,062,348	196,311,529	195,852,404
Diluted weighted average shares	199,452,308	198,254,808	199,290,017	198,028,543

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

2

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Blue Buffalo Pet Products, Inc.

Unaudited Condensed Consolidated Statements of Comprehensive Income

(dollars in thousands)

	Three Months		Nine Months	
	Ended September		Ended September	
	30,	30,	30,	30,
	2016	2015	2016	2015
Net income	\$21,482	\$27,066	\$95,439	\$79,750
Other comprehensive income (loss):				
Foreign currency translation adjustment	6	—	72	—
Other comprehensive income (loss), before tax	6	—	72	—
Income tax expense on other comprehensive income (loss)	—	—	—	—
Other comprehensive income (loss), net of tax	6	—	72	—
Comprehensive income	\$21,488	\$27,066	\$95,511	\$79,750

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

3

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Blue Buffalo Pet Products, Inc.

Unaudited Condensed Consolidated Statement of Changes in Stockholders' Equity (Deficit)

(dollars in thousands, except for share amounts)

	Common shares outstanding	Common stock	Additional paid-in capital	(Accumulated deficit) retained earnings	Accumulated other comprehensive (loss)	Total
Balance at December 31, 2015	196,216,596	\$ 1,962	\$ 64,899	\$ (57,549)	\$ (31)	\$ 9,281
Other comprehensive income	—	—	—	—	72	72
Issuance of restricted stock awards	31,871	—	814	—	—	814
Exercise of stock options	266,813	3	1,802	—	—	1,805
Tax benefit from exercise of stock options	—	—	—	—	—	—
Stock-based compensation expense	—	—	2,237	—	—	2,237
Net income	—	—	—	95,439	—	95,439
Balance at September 30, 2016	196,515,280	\$ 1,965	\$ 69,752	\$ 37,890	\$ 41	\$ 109,648

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

4

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Blue Buffalo Pet Products, Inc.
 Unaudited Condensed Consolidated Statements of Cash Flows
 (dollars in thousands)

	Nine Months Ended September 30, 2016	2015
Cash flows from operating activities:		
Net income	\$ 95,439	\$ 79,750
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,766	5,981
Amortization of debt issuance costs	91	91
Stock-based compensation	3,051	2,935
Deferred compensation	—	19
(Gain) loss on disposal of fixed assets	(2)	69
Deferred income taxes	3,061	(1,790)
Tax benefit from exercise of stock options	—	(1,551)
Provision for legal settlement	32,000	—
Payment of class action legal settlement	(32,000)	—
Effect of changes in operating assets and liabilities:		
Receivables	(12,282)	2,178
Inventories	8,257	(8,282)
Prepaid expenses and other assets	(2,066)	(3)
Accounts payable	4,055	4,387
Other liabilities	5,158	10,263
Net cash provided by operating activities	111,528	94,047
Cash flows from investing activities:		
Capital expenditures	(17,901)	(5,374)
Restricted cash	(308)	—
	15	—

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Proceeds from the sale of fixed assets				
Net cash used in investing activities	(18,194)	(5,374)
Cash flows from financing activities:				
Principal payments on long-term debt	(2,970)	(2,970)
Proceeds from exercise of stock options	1,805		1,910	
Tax benefit from exercise of stock options	—		1,551	
Net cash (used in) provided by financing activities	(1,165)	491	
Effect of exchange rate changes on cash and cash equivalents	(60)	—	
Net increase in cash and cash equivalents	92,109		89,164	
Cash and cash equivalents at beginning of period	224,253		95,788	
Cash and cash equivalents at end of period	\$ 316,362		\$ 184,952	

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

5

Blue Buffalo Pet Products, Inc.
Notes to Unaudited Condensed Consolidated Financial Statements

Note 1 – The Company

Blue Buffalo Pet Products, Inc. (“BBPP”) and together with its subsidiaries (the “Company,” “we,” “us,” “its,” and “our”) was incorporated in the state of Delaware in July 2012 and conducts its business exclusively through its wholly-owned operating subsidiary, Blue Buffalo Company, Ltd. (“Blue”) (formerly The Blue Buffalo Company, LLC) and its subsidiaries. Blue was formed in August 2002, and is the parent company of five wholly-owned subsidiaries: Great Plains Leasing, LLC, Heartland Pet Food Manufacturing Holding, LLC, Sierra Pet Products, LLC, Blue Buffalo Pet Products Canada, Ltd., and Blue Buffalo Japan Kabushiki Kaisha. Additionally, Blue Buffalo Import Mexico, S. de R.L. de C.V. and Blue Buffalo Mexico, S. de R.L. de C.V. are indirect wholly-owned subsidiaries of BBPP. BBPP and its subsidiaries develop, produce, market, and sell pet food under the BLUE Life Protection Formula, BLUE Wilderness, BLUE Basics, BLUE Freedom, and BLUE Natural Veterinary Diet lines. Our products are produced domestically at our Heartland facility and through contract manufacturers for distribution to retailers in specialty channels throughout the United States of America, Canada, Japan, and Mexico.

In July 2012, Blue formed Heartland Pet Food Manufacturing, Inc. (“Heartland”) for the purpose of commencing internal manufacturing operations to eventually supplement its contract manufacturers. Manufacturing operations commenced at our Heartland facility in Joplin, Missouri in September 2014. In April 2016, Blue formed Heartland Pet Food Manufacturing Holding, LLC for the purpose of consolidating all manufacturing entities under one holding company. In April 2016, Heartland Pet Food Manufacturing Indiana, LLC was formed for our planned internal manufacturing operations in Indiana.

Initial Public Offering

On July 27, 2015, BBPP completed the initial public offering (“IPO”) of shares of its common stock. Existing stockholders of BBPP sold 38,906,286 shares of common stock in the IPO at an initial offering price of \$20.00 per share, including 5,074,732 shares of common stock pursuant to the full exercise of the underwriters’ option to purchase additional shares. In addition, BBPP issued 30,682 shares of common stock to approximately 1,700 non-management employees at no cost to them.

Secondary Public Offerings

On July 5, 2016, BBPP completed a secondary public offering (“SPO”) of shares of its common stock. Certain existing stockholders of BBPP sold 17,250,000 shares of common stock at a SPO price of \$22.00 per share, including 2,250,000 shares of common stock pursuant to the full exercise of the underwriters’ option to purchase additional shares.

On September 16, 2016, BBPP completed an additional SPO of shares of its common stock. Certain existing stockholders of BBPP sold 14,300,000 shares of common stock at a SPO price of \$25.62 per share.

Note 2 – Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include the accounts of BBPP and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

The unaudited condensed consolidated financial statements reflect all normal recurring adjustments which, in management’s opinion, are necessary for a fair statement of the results for interim periods. Results of

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

operations for interim periods may not be representative of results to be expected for a full year. Certain prior year amounts have been reclassified to conform to the current period presentation.

On July 7, 2015, BBPP effected a 4.2-for-1 stock split of all outstanding shares of BBPP's common stock. All share, option, and per share information presented in the accompanying unaudited condensed consolidated financial statements have been adjusted to reflect the stock split on a retroactive basis for all periods presented and all share information is rounded down to the nearest whole share after reflecting the stock split.

Certain information and footnote disclosure normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These unaudited condensed consolidated financial statements should be read in conjunction with the Company's annual consolidated financial statements and related notes for the year ended December 31, 2015, included in BBPP's Annual Report on Form 10-K, filed with the SEC pursuant to Rule 424(b) of the Securities Act, on March 10, 2016.

Accounting Standards Adopted in 2016

In March 2016, the FASB Issued ASU No. 2016-09, "Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). The updated guidance changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. The Company elected to early adopt ASU 2016-09 in the third quarter of Fiscal 2016 which requires the Company to reflect any adjustments as of January 1, 2016, the beginning of the annual period that includes the interim period of adoption. Under ASU 2016-09, all excess tax benefits and deficiencies related to employee share-based compensation will be recognized within the provision for income taxes rather than additional paid-in capital under the prior guidance. The adoption of ASU 2016-09 resulted in the recognition of excess tax benefits in our provision for income taxes of \$1.4 million for the nine months ended September 30, 2016. Upon early adopting ASU 2016-09, the Company elected to change its accounting policy to record forfeitures as they occur rather than based on an estimate. This change was applied on a modified retrospective basis and the cumulative-effect adjustment was not recorded to retained earnings as of January 1, 2016 as the amount was immaterial.

Additionally, under the guidance of ASU 2016-09, the Company is required to present excess tax benefits as an operating activity in the same manner as other cash flows related to income taxes on the statement of cash flows rather than as a financing activity. The Company elected not to adjust prior year cash presentations as the impact was not material.

In August 2015, the FASB issued ASU No. 2015-15, "Presentation and Subsequent Measurement of Debt Issuance Costs Associated with Line-of-Credit Arrangements—Amendments to SEC Paragraphs Pursuant to Staff Announcement at June 18, 2015 EITF Meeting (SEC Update)." The new standard is intended to address the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements which was previously not addressed in ASU No. 2015-03, "Simplifying the Presentation of Debt Issuance Costs." The Company adopted this standard on January 1, 2016. The adoption of this standard did not have a material impact on the Company's results of operations, cash flows or financial position.

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

Accounting Standards to be Adopted

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers (Topic 606), which clarifies the principles for recognizing revenue. The guidance is applicable to all contracts with customers regardless of industry-specific or transaction-specific fact patterns. Further, the guidance requires improved disclosures as well as additional disclosures to help users of financial statements better understand the nature, amount, timing and uncertainty of revenue that is recognized. In 2015, the FASB issued a deferral of the effective date of the standard to the first quarter of 2018, with early adoption in Fiscal 2017 permitted. In 2016, FASB issued final amendments clarifying the implementation guidance for principal versus agent considerations, identifying performance obligations and the accounting for intellectual property licenses. Upon becoming effective, the Company will apply the amendments in the updated standard either retrospectively to each prior reporting period presented, or retrospectively with the cumulative effect of initially applying the guidance recognized at the date of initial application. The Company is currently evaluating the impact of adopting this standard on its consolidated results of operations, financial condition and cash flows, and have not yet selected a transition approach.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842) that replaces existing lease guidance. The new standard is intended to provide enhanced transparency and comparability of organizations by requiring lease assets and lease liabilities to be recognized on the balance sheet and disclosing key information about lease arrangements. The new guidance will continue to classify leases as either finance or operating, with classification affecting the pattern of expense recognition in the statement of income. The standard is effective for the Company beginning January 1, 2019, with early application permitted. The new standard is required to be applied with a modified retrospective approach to each prior reporting period presented with various optional practical expedients. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements. In August 2016, the FASB issued ASU No. 2016-15, “Classification of Certain Cash Receipts and Cash Payments,” which amends ASC 230, Statement of Cash Flows. This ASU provides guidance on the statement of cash flows presentation of certain transactions where diversity in practice exists. The guidance is effective for interim and annual periods beginning after December 15, 2017, and early adoption is permitted. The Company is currently evaluating the impact of adopting this standard on its consolidated financial statements.

Note 3 – Receivables

Receivables consisted of the following:

(dollars in thousands)	September 30, 2016	December 31, 2015
Trade receivables, net	\$ 84,148	\$ 66,648
Other receivables	8,250	13,455
Total	\$ 92,398	\$ 80,103

Other receivables consist primarily of reimbursable amounts due from co-manufacturers for packaging of \$3.3 million and \$3.5 million and income tax receivables of \$4.9 million and \$9.5 million at September 30, 2016 and December 31, 2015, respectively.

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

Note 4 – Inventories

Inventories consisted of the following:

(dollars in thousands)	September 30, 2016	December 31, 2015
Finished goods	\$ 69,746	\$ 76,987
Work in process	354	352
Raw materials	2,558	2,583
Packaging and supplies	2,742	3,560
Total	\$ 75,400	\$ 83,482

Note 5 – Property, Plant and Equipment

Property, plant and equipment consisted of the following:

(dollars in thousands)	September 30, 2016	December 31, 2015
Buildings	\$ 59,314	\$ 59,315
Machinery and equipment	49,058	47,234
Computer software	13,087	11,641
Computer equipment	4,523	4,055
Furniture and fixtures	1,743	1,585
Leasehold improvements	1,477	1,413
Land improvements	493	493
Land	366	346
Buildings improvements	184	86
Construction in progress	17,443	3,673
	147,688	129,841
Accumulated depreciation and amortization	(21,406)	(14,681)
Total	\$ 126,282	\$ 115,160

Depreciation and amortization expense was approximately \$2.3 million and \$2.1 million for the three months ended September 30, 2016 and 2015, respectively, and approximately \$6.8 million and \$6.0 million for the nine months ended September 30, 2016 and 2015, respectively.

In August of 2016, Heartland and the City of Joplin, Missouri, or Joplin, entered into agreements by which Joplin agreed to issue up to an aggregate principal amount of approximately \$83.3 million of industrial revenue bonds to purchase the land on which the current Heartland facility resides and the land on which the expansion of the Heartland facility will reside, and the associated buildings, structures, and fixtures, including the additional manufacturing equipment which will be included in the expansion of the Heartland facility (collectively, the “Property”). Heartland agreed to purchase such industrial revenue bonds and which Property was then agreed to be leased back to Heartland. As Heartland will become the owner of the Property at the end of the lease term, the lease meets the requirements of a capital lease and the equipment and land are recorded as property, plant and equipment on our balance sheet. The Company has the right and intends to set-off any obligation to make payments under the lease agreement with the amounts due under the industrial revenue bonds. As of September 30, 2016, Joplin had issued and Heartland had purchased approximately \$0.1 million of industrial revenue bonds and Joplin had purchased from, and leased back to,

Heartland the land for a corresponding amount.

9

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

Note 6 – Long-term Debt

Long-term debt consisted of the following:

(dollars in thousands)	September 30, 2016	December 31, 2015
Term loan	\$ 384,127	\$ 387,097
Less current maturities	(3,960)	(3,960)
Total long-term debt	\$ 380,167	\$ 383,137

At September 30, 2016, we had \$384.1 million of term loan borrowings (fair value of \$385.6 million) at an effective interest rate of 3.63% and no outstanding borrowings under the revolving credit facility. At December 31, 2015, the Company had \$387.1 million of term loan borrowings (fair value of \$385.2 million) at an effective interest rate of 3.87% and no outstanding borrowings under the revolving credit facility. Principal payments on the term loan borrowings are due and payable in quarterly installments of approximately \$1.0 million with the then expected remaining balance of \$373.2 million due on August 8, 2019.

During each of the three-month periods ended September 30, 2016 and 2015, the Company recorded amortization expense for deferred debt issuance costs of approximately \$30,000. During each of the nine-month periods ended September 30, 2016 and September 30, 2015, the Company recorded amortization expense for deferred debt issuance costs of approximately \$91,000.

The Company's term loan and revolving credit facility (the "Amended Facility") contains and defines financial covenants, including a secured leverage ratio (defined as, with certain adjustments, the ratio of (i) the Company's indebtedness less unrestricted cash and cash equivalents up to \$40.0 million to (ii) consolidated net income before interest, taxes, depreciation and amortization) for the most recently ended 4 quarters not to exceed 3.75:1.00. The Amended Facility also sets forth mandatory and optional prepayment conditions, including an annual excess cash flow requirement, as defined, that may result in our use of cash to reduce our debt obligations. For the year ended December 31, 2015, the Company was not required to make an excess cash flow payment. As of September 30, 2016, the Company believes it was in compliance with its financial debt covenants.

Note 7 – Fair Value Measurements

The Company's financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, other current liabilities, and debt, none of which are measured at fair value on a recurring basis. The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and other current liabilities approximate their fair value due to the short-term nature of these financial instruments. The Company's long-term financial liabilities consist of the long-term debt. Long-term debt is recorded on the unaudited condensed consolidated balance sheets at issuance price and adjusted for any applicable unamortized discounts or premiums.

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

The Company accounts for its fair value measurements in accordance with accounting guidance which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. The fair value hierarchy for disclosure of fair value measurements is as follows:

Level 1- Quoted prices in active markets for identical assets or liabilities

Level 2- Quoted prices for similar assets and liabilities in active markets or inputs that are observable

Level 3- Inputs that are unobservable (for example, cash flow modeling inputs based on assumptions)

At September 30, 2016 and December 31, 2015, the Company had approximately \$285.7 million and \$195.4 million, respectively, of cash invested in money market deposit accounts which were included in cash and cash equivalents on the accompanying unaudited condensed consolidated balance sheets (Level 1).

The Company reports transfers in and out of Levels 1, 2 and 3, as applicable, using the fair value of the individual securities as of the beginning of the reporting period in which the transfer(s) occurred. There were no transfers in or out of Level 1, 2, or 3 during the nine months ended September 30, 2016 and the year ended December 31, 2015.

Assets that are measured at fair value on a nonrecurring basis relate primarily to our tangible fixed assets. For these assets, the Company does not periodically adjust carrying value to fair value, except in the event of impairment. When the Company determines that an impairment has occurred, the carrying value is reduced to fair value and the difference is recorded as an impairment loss in our consolidated statements of income.

As of September 30, 2016, the carrying value of the Company's outstanding borrowings under the Amended Facility was approximately \$384.1 million as compared to a fair value of \$385.6 million (Level 2). As of December 31, 2015, the carrying value of the Company's outstanding borrowings under the Amended Facility was approximately \$387.1 million as compared to a fair value of \$385.2 million (Level 2). The estimated fair value of the Company's debt was based primarily on reported market values, recently completed market transactions and estimates based upon interest rates, maturities and credit risk.

Note 8 – Stock-Based Compensation

Incentive Plans

Under the Company's 2012 Blue Buffalo Pet Products, Inc. Stock Purchase and Option Plan (the "Plan"), the Board of Directors is authorized to award stock options (ISOs and non-qualified), stock appreciation rights (SARs), restricted stock, performance units, performance-based stock awards, dividend equivalent rights and other stock-based grants. Participation in the Plan is limited to key employees, officers and directors.

On March 4, 2013, the Plan was amended to increase the maximum number of shares of stock available under the Plan by 210,000 shares to 14,242,061 shares (the "Amended Plan"). As of September 30, 2016, there were 5,230,642 shares of common stock reserved under the Amended Plan. As of September 30, 2016, the maximum number of shares available for grant under the Amended Plan was 89,035.

In July 2015, the Board of Directors adopted and our shareholders approved the Company's 2015 Omnibus Incentive Plan ("2015 Plan"). The 2015 Plan provides that the total number of shares of common stock that

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

may be issued under our 2015 Plan is 8,400,000. The 2015 Plan provides for the grant of stock options (ISOs and non-qualified), SARs, restricted stock awards (RSAs), restricted stock units (RSUs), performance units, performance-based stock awards, dividend equivalent rights and other stock-based incentive awards. As of September 30, 2016, the maximum number of shares available for grant under the 2015 Plan was 7,843,075.

Stock Options

The Company uses the Black-Scholes option-pricing model to determine the fair value of stock options on the date of grant. Stock options granted under the 2012 plan are subject to pro-rata vesting and grants under the 2015 Plan are subject to cliff vesting. The fair value of stock options is expensed on a straight-line basis over the vesting period.

Prior to the Company's initial public offering, the Company used a third party valuation specialist to assist it in the estimation of the fair value of its common stock. The Company believed these valuations to be appropriate; however, the valuation of the equity of any private company involves various estimates and assumptions that may differ from actual values. Effective with our initial public offering, the Company bases its common stock value on quoted market prices. The expected volatility assumption is based on the combination of the Company's historical volatility and selected companies from its peer group. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury implied yield at the date of grant. The weighted-average expected term is determined with reference to historical exercise and post-vesting cancellation experience, and the vesting period and contractual term of the awards.

The following are the weighted-average assumptions used for grants issued during the nine month periods ended September 30:

	2016	2015
Volatility	32.58 %	23.85 %
Risk-free interest rate	1.23 %	1.88 %
Expected term (years)	5	6.5
Dividend yield	—	—
Grant-date fair value	\$7.81	\$5.74

The following table summarizes stock option activity during the year and also presents stock options outstanding and exercisable as of September 30, 2016 (dollars in millions, except for per share data):

	Number of Shares	Weighted Average Exercise Price Per Share
Options outstanding at December 31, 2015	4,366,297	\$ 6.24
Granted	396,688	\$ 25.47
Exercised	(266,813)	\$ 6.54
Forfeited	(69,417)	\$ 13.59
Expired	(11,566)	\$ 6.97
Options outstanding at September 30, 2016	4,415,189	\$ 7.83
Options exercisable at September 30, 2016	2,102,214	\$ 5.80

Blue Buffalo Pet Products, Inc.

Notes to Unaudited Condensed Consolidated Financial Statements (Continued)

During the three and nine months ended September 30, 2016, the Company granted 20,166 and 130,208 ISO and 834 and 266,480 non-qualified stock option grants, respectively.

Restricted Stock

The following table summarizes RSA and RSU activity for the nine months ended September 30, 2016: