DOLLAR GENERAL CORP
Form 10-Q
August 28, 2014

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 August 1, 2014

Commission File Number: 001-11421

DOLLAR GENERAL CORPORATION

(Exact name of Registrant as specified in its charter)

TENNESSEE	**61-0502302**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*

100 MISSION RIDGE
GOODLETTSVILLE, TN 37072
(Address of principal executive offices, zip code)

Registrant s telephone number, including area code: (615) 855-4000

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 Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T 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 the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer [X]	Accelerated filer [ ]
Non-accelerated filer [ ]	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 [ ] No [X]

The registrant had 303,397,106 shares of common stock outstanding on August 25, 2014.

PART I FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	August 1, 2014 (Unaudited)	January 31, 2014 (see Note 1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 172,474	$ 505,566
Merchandise inventories	2,788,872	2,552,993
Income taxes receivable	4,237	-
Prepaid expenses and other current assets	175,048	147,048
Total current assets	3,140,631	3,205,607
Net property and equipment	2,106,963	2,080,305
Goodwill	4,338,589	4,338,589
Other intangible assets, net	1,203,904	1,207,645
Other assets, net	35,707	35,378
Total assets	$ 10,825,794	$ 10,867,524
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 101,013	$ 75,966
Accounts payable	1,395,780	1,286,484
Accrued expenses and other	427,269	368,578
Income taxes payable	23,922	59,148
Deferred income taxes	21,434	21,795
Total current liabilities	1,969,418	1,811,971
Long-term obligations	2,881,217	2,742,788
Deferred income taxes	582,883	614,026
Other liabilities	296,283	296,546
Commitments and contingencies		
Shareholders equity:		
Preferred stock	-	-
Common stock	265,458	277,424
Additional paid-in capital	3,027,985	3,009,226
Retained earnings	1,811,358	2,125,453
Accumulated other comprehensive loss	(8,808)	(9,910)
Total shareholders equity	5,095,993	5,402,193
Total liabilities and shareholders equity	$ 10,825,794	$ 10,867,524

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

(In thousands, except per share amounts)

	For the 13 weeks ended		For the 26 weeks ended	
	August 1, 2014	August 2, 2013	August 1, 2014	August 2, 2013
Net sales	$ 4,724,039	$ 4,394,651	$ 9,246,120	$ 8,628,384
Cost of goods sold	3,268,465	3,017,361	6,432,800	5,955,946
Gross profit	1,455,574	1,377,290	2,813,320	2,672,438
Selling, general and administrative expenses	1,027,048	964,468	2,005,086	1,864,616
Operating profit	428,526	412,822	808,234	807,822
Interest expense	22,598	20,631	44,865	45,147
Other (income) expense	-	-	-	18,871
Income before income taxes	405,928	392,191	763,369	743,804
Income tax expense	154,668	146,716	289,711	278,246
Net income	$ 251,260	$ 245,475	$ 473,658	$ 465,558
Earnings per share:				
Basic	$ 0.83	$ 0.76	$ 1.55	$ 1.43
Diluted	$ 0.83	$ 0.75	$ 1.54	$ 1.42
Weighted average shares outstanding:				
Basic	303,015	324,770	306,173	325,872
Diluted	303,888	325,639	307,091	326,886

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

(In thousands)

	For the 13 weeks ended		For the 26 weeks ended	
	August 1, 2014	August 2, 2013	August 1, 2014	August 2, 2013
Net income	$ 251,260	$ 245,475	$ 473,658	$ 465,558
Unrealized net gain (loss) on hedged transactions, net of related income tax expense (benefit) of $450, $793, $718, and $(4,835), respectively	704	1,209	1,102	(7,559)
Comprehensive income	$ 251,964	$ 246,684	$ 474,760	$ 457,999

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

(In thousands)

	For the 26 weeks ended	
	August 1, 2014	August 2, 2013
Cash flows from operating activities:		
Net income	$ 473,658	$ 465,558
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	169,498	163,237
Deferred income taxes	(38,880)	5,163
Tax benefit of share-based awards	(10,994)	(23,717)
Loss on debt retirement, net	-	18,871
Noncash share-based compensation	18,320	10,843
Other noncash gains and losses	3,539	(176)
Change in operating assets and liabilities:		
Merchandise inventories	(235,890)	(133,414)
Prepaid expenses and other current assets	(29,055)	(14,245)
Accounts payable	104,382	(10,855)
Accrued expenses and other liabilities	61,977	65,737
Income taxes	(28,469)	(61,584)
Other	(1,162)	(1,303)
Net cash provided by (used in) operating activities	486,924	484,115
Cash flows from investing activities:		
Purchases of property and equipment	(191,414)	(308,526)
Proceeds from sales of property and equipment	692	258
Net cash provided by (used in) investing activities	(190,722)	(308,268)
Cash flows from financing activities:		
Issuance of long-term obligations	-	2,297,177
Repayments of long-term obligations	(26,672)	(2,119,536)
Borrowings under revolving credit facilities	972,000	823,900
Repayments of borrowings under revolving credit facilities	(782,000)	(902,800)
Debt issuance costs	-	(15,996)
Payments for cash flow hedge related to debt issuance	-	(13,217)
Repurchases of common stock	(800,095)	(219,981)
Other equity transactions, net of employee taxes paid	(3,521)	(20,700)
Tax benefit of share-based awards	10,994	23,717
Net cash provided by (used in) financing activities	(629,294)	(147,436)
Net increase (decrease) in cash and cash equivalents	(333,092)	28,411
Cash and cash equivalents, beginning of period	505,566	140,809
Cash and cash equivalents, end of period	$ 172,474	$ 169,220
Supplemental schedule of non-cash investing and financing activities:		
Purchases of property and equipment awaiting processing for payment, included in Accounts payable	$ 31,996	$ 43,251

See notes to condensed consolidated financial statements.

DOLLAR GENERAL CORPORATION AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of presentation

The accompanying unaudited condensed consolidated financial statements of Dollar General Corporation and its subsidiaries (the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP) for interim financial information and are presented in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X. Such financial statements consequently do not include all of the disclosures normally required by U.S. GAAP or those normally made in the Company s Annual Report on Form 10-K, including the condensed consolidated balance sheet as of January 31, 2014 which has been derived from the audited consolidated financial statements at that date. Accordingly, readers of this Quarterly Report on Form 10-Q should refer to the Company s Annual Report on Form 10-K for the fiscal year ended January 31, 2014 for additional information.

The Company s fiscal year ends on the Friday closest to January 31. Unless the context requires otherwise, references to years contained herein pertain to the Company s fiscal year. The Company s 2014 fiscal year will be a 52-week accounting period ending on January 30, 2015, and the 2013 fiscal year was a 52-week accounting period that ended on January 31, 2014.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with the Company s customary accounting practices. In management s opinion, all adjustments (which are of a normal recurring nature) necessary for a fair presentation of the consolidated financial position as of August 1, 2014 and results of operations for the 13-week and 26-week accounting periods ended August 1, 2014 and August 2, 2013 have been made.

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

The Company uses the last-in, first-out (LIFO) method of valuing inventory. An actual valuation of inventory under the LIFO method is made at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management s estimates of expected year-end inventory levels, sales for the year and the expected rate of inflation or deflation for the year. The interim LIFO calculations are subject to adjustment in the final year-end LIFO inventory valuation. The Company recorded a LIFO provision (benefit) of $0.8 million and $(2.4) million in the respective 13-week periods, and $0.9 million and $(2.8) million in the respective 26-week periods, ended August 1, 2014 and August 2, 2013. In addition, ongoing estimates of inventory shrinkage and initial markups and markdowns are included in the interim cost of goods sold calculation. Because the Company s business is moderately seasonal, the results for interim periods are not necessarily indicative of the results to be expected for the entire year.

In July 2013, the Financial Accounting Standards Board issued an accounting standards update which relates to the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. The Company s adoption of this guidance in the first quarter of 2014 did not have a material effect on the Company s condensed consolidated financial statements.

In May 2014, the Financial Accounting Standards Board issued comprehensive new accounting standards related to the recognition of revenue. This guidance is effective for annual reporting periods beginning after December 15, 2016, and early adoption is not permitted. The new guidance allows for companies to use either a full retrospective or a modified retrospective approach in the adoption of this guidance, and the Company is evaluating these transition approaches. The Company will adopt this guidance in the first quarter of 2017 and is currently in the process of evaluating the effect of adoption on its consolidated financial statements.

Certain financial statement amounts relating to prior periods may have been reclassified to conform to the current period presentation where applicable.

2. Earnings per share

Earnings per share is computed as follows (in thousands, except per share data):

	13 Weeks Ended August 1, 2014			13 Weeks Ended August 2, 2013		
	Net Income	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic earnings per share	$ 251,260	303,015	$ 0.83	$ 245,475	324,770	$ 0.76
Effect of dilutive share-based awards		873			869	
Diluted earnings per share	$ 251,260	303,888	$ 0.83	$ 245,475	325,639	$ 0.75

	26 Weeks Ended August 1, 2014			26 Weeks Ended August 2, 2013		
	Net Income	Shares	Per Share Amount	Net Income	Shares	Per Share Amount
Basic earnings per share	$ 473,658	306,173	$ 1.55	$ 465,558	325,872	$ 1.43
Effect of dilutive share-based awards		918			1,014	
Diluted earnings per share	$ 473,658	307,091	$ 1.54	$ 465,558	326,886	$ 1.42

Basic earnings per share is computed by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is determined based on the dilutive effect of share-based awards using the treasury stock method.

Share-based awards that were outstanding at the end of the respective periods, but were not included in the computation of diluted earnings per share because the effect of exercising such awards would be antidilutive, were 1.7 million and 1.5 million in the 2014 and 2013 13-week periods, respectively.

3. Income taxes

Under the accounting standards for income taxes, the asset and liability method is used for computing the future income tax consequences of events that have been recognized in the Company s consolidated financial statements or income tax returns.

Income tax reserves are determined using the methodology established by accounting standards for income taxes which require companies to assess each income tax position taken using the following two-step approach. A determination is first made as to whether it is more likely than not that the position will be sustained, based upon the technical merits, upon examination by the taxing authorities. If the tax position is expected to meet the more likely than not criteria, the benefit recorded for the tax position equals the largest amount that is greater than 50% likely to be realized upon ultimate settlement of the respective tax position.

The Internal Revenue Service (IRS) has previously examined the Company s 2008 and earlier federal income tax returns. As a result, the 2008 and earlier tax years are not open for further examination by the IRS. The Company has filed an amended federal income tax return requesting a refund of approximately $5.1 million for its 2009 tax year. This amended return is being examined by the IRS. As the statute of limitations has otherwise closed for the 2009 tax year, the IRS s ability to assess additional income tax for 2009 is limited to the refund requested on the amended income tax return. The IRS, at its discretion, may choose to examine the Company s 2010 through 2013 fiscal year income tax filings. The Company has various state income tax examinations that are currently in progress. Generally, the Company s 2010 and later tax years remain open for examination by the various state taxing authorities.

As of August 1, 2014, the total reserves for uncertain tax benefits, interest expense related to income taxes and potential income tax penalties were $17.2 million, $2.1 million and $0.4 million, respectively, for a total of $19.7 million. Of this amount, $0.5 million and $19.2 million are reflected in current liabilities as Accrued expenses and other and in noncurrent Other liabilities, respectively, in the condensed consolidated balance sheet.

The Company believes it is reasonably possible that the reserve for uncertain tax positions may be reduced by approximately $8.7 million in the coming twelve months principally as a result of the effective settlement of uncertain tax positions. As of August 1, 2014, approximately $17.2 million of the reserve for uncertain tax positions would impact the Company s effective income tax rate if the Company were to recognize the tax benefit for these positions.

The effective income tax rates for the 13-week and 26-week periods ended August 1, 2014 were 38.1% and 38.0%, respectively, compared to a rate of 37.4% for both the 13-week and 26-week periods ended August 2, 2013. Both the 13-week and 26-week effective income tax rate increased due to the expiration of various federal job credit programs (primarily the Work Opportunity Tax Credit) for eligible employees hired after December 31, 2013. Partially offsetting this tax rate increase for the 26-week period were benefits recognized due to the favorable resolution of state tax examinations. A similar benefit was not recognized in the 13-week period.

4. Current and long-term obligations

On April 11, 2013, the Company consummated a refinancing pursuant to which it terminated its existing senior secured credit agreements, entered into a new five-year unsecured credit agreement, and issued senior notes due in 2018 and 2023 as discussed in greater detail below. The Company s senior unsecured credit facilities (the Facilities) consist of a senior unsecured term loan facility (the Term Facility), which had an initial balance of $1.0 billion, and an $850.0 million senior unsecured revolving credit facility (the Revolving Facility), which provides for the issuance of letters of credit up to $250.0 million. The Term Facility amortizes in quarterly installments of $25.0 million, and the first such payment was made on August 1, 2014. The final quarterly payment of the then-remaining balance will be due at maturity on April 11, 2018. The Company capitalized $5.9 million of debt issuance costs associated with the Facilities, the amortized balance of which is included in long-term Other assets, net in the condensed consolidated balance sheet.

As of August 1, 2014, the balance of the Term Facility was $975.0 million, and under the Revolving Facility, the Company had total outstanding borrowings of $190.0 million, outstanding letters of credit of $31.2 million, and borrowing availability of $628.8 million. Also as of August 1, 2014, the Company had letters of credit totaling $19.7 million which were not issued under the Revolving Facility.

The Company incurred a pretax loss of $18.9 million for the write off of debt issuance costs associated with the termination of its previous credit facilities, which is reflected in Other (income) expense in the condensed consolidated statement of income for the 26-week period ended August 2, 2013.

On April 11, 2013, the Company issued $400.0 million aggregate principal amount of 1.875% senior notes due 2018, net of discount of $0.5 million, which mature on April 15, 2018, and issued $900.0 million aggregate principal amount of 3.25% senior notes due 2023, net of discount of $2.4 million, which mature on April 15, 2023. The Company capitalized $10.1 million of debt issuance costs associated with these issuances of senior notes, the amortized balance of which is included in long-term Other assets, net in the condensed consolidated balance sheet.

5. Assets and liabilities measured at fair value

Fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, fair value accounting standards establish a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity s own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

In connection with accounting standards for fair value measurement, the Company has made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio. The Company has determined that the majority of the inputs used to value its derivative financial instruments using the income approach fall within Level 2 of the fair value hierarchy. However, the credit valuation adjustments associated with the Company s derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by the Company and its counterparties. As of August 1, 2014, the Company has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that such adjustments are not significant to the derivatives valuation. As a result, the Company has classified its derivative valuations, as discussed in detail in Note 6, in Level 2 of the fair value hierarchy. The Company s long-term obligations that are classified in Level 2 of the fair value hierarchy are valued at cost. The Company does not have any fair value measurements categorized within Level 3 as of August 1, 2014.

(in thousands)	Quoted Prices in Active Markets for Identical Assets and Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance at August 1, 2014
Liabilities:				
Long-term obligations (a)	2,938,547	19,665	-	2,958,212
Derivative financial instruments (b)	-	2,947	-	2,947
Deferred compensation (c)	22,799	-	-	22,799

(a) Reflected at book value in the condensed consolidated balance sheet as Current portion of long-term obligations of $101,013 and Long-term obligations of $2,881,217.

(b) Reflected at fair value in the condensed consolidated balance sheet as Accrued expenses and other current liabilities.

(c) Reflected at fair value in the condensed consolidated balance sheet as Accrued expenses and other current liabilities of $1,735 and noncurrent Other liabilities of $21,064.

6. Derivatives and hedging activities

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge.

The Company may enter into derivative contracts that are intended to economically hedge a certain portion of its risk, even though hedge accounting does not apply or the Company elects not to apply the hedge accounting standards. Changes in the fair value of such derivatives are recorded directly in earnings.

Risk management objective of using derivatives

The Company is exposed to certain risks arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its debt funding and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined primarily by interest rates. The Company s derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company s known or expected cash receipts and its known or expected cash payments principally related to the Company s borrowings.

In addition, the Company is exposed to certain risks arising from uncertainties of future market values caused by the fluctuation in the prices of commodities. From time to time the Company may enter into derivative financial instruments to protect against future price changes related to these commodity prices.

Cash flow hedges of interest rate risk

The Company s objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate changes. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

The effective portion of changes in the fair value of interest rate swaps designated and that qualify as cash flow hedges is recorded in Accumulated other comprehensive income (loss) (also referred to as OCI) and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During the 13-week and 26-week periods ended August 1, 2014 and August 2, 2013, such interest rate swaps were used to hedge the variable cash flows associated with variable-rate debt. The ineffective portion of the change in fair value of the interest rate swaps, if any, is recognized directly in earnings.

As of August 1, 2014, the Company had interest rate swaps with a combined notional value of $875.0 million that were designated as cash flow hedges of interest rate risk. Amounts reported in Accumulated other comprehensive income (loss) related to these derivatives will be reclassified to interest expense as interest payments are made on the Company s variable-rate debt.

During the 26-week period ended August 2, 2013, the Company entered into U.S. Treasury locks related to its issuance of senior notes due April 15, 2023, as further discussed in Note 4. The settlement of the U.S. Treasury locks resulted in a loss which was deferred to OCI and is being amortized as an increase to interest expense over the period corresponding to the debt s maturity as the Company accrues or pays interest on the hedged long-term debt.

During the 52-week period following August 1, 2014, the Company estimates that approximately $4.3 million will be reclassified as an increase to interest expense for its interest rate swaps and U.S. Treasury locks.

All of the amounts reflected in Accumulated other comprehensive income (loss) in the condensed consolidated balance sheets for the periods presented are related to cash flow hedges.

The table below presents the fair value of the Company s derivative financial instruments as well as their classification in the condensed consolidated balance sheets as of August 1, 2014 and January 31, 2014:

(in thousands)		August 1, 2014		January 31, 2014
Derivatives Designated as Hedging Instruments				
Interest rate swaps classified as noncurrent Other liabilities	$	-	$	4,109
Interest rate swaps classified as Accrued expenses and other current liabilities	$	2,947	$	-

The table below presents the pre-tax effect of the Company s derivative financial instruments as reflected in the condensed consolidated statements of comprehensive income for the 13-week and 26-week periods ended August 1, 2014 and August 2, 2013:

	13 Weeks Ended				26 Weeks Ended	
(in thousands)		August 1, 2014		August 2, 2013	August 1, 2014	August 2, 2013
Derivatives in Cash Flow Hedging Relationships						
(Gain) loss related to effective portion of derivatives recognized in OCI	$	139	$	(809)		