



THE SECOND CUP LTD.

# Annual Report 2016



**SECOND CUP  
COFFEE CO.™**

## VISION

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To be the coffee brand most passionately committed to quality and innovation.



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# Letter from the Chairman



Over the past three years, Second Cup has vastly improved as a company. After taking necessary bold action to repair serious structural issues, the company's foundation is much more secure. Second Cup has invested heavily to improve franchisee profitability. Successful franchisees are the lifeblood of Second Cup.

While much damage has been repaired, the company has struggled to resume its growth trajectory. We aim to see improvement in key measures including average sales per store, same store sales growth, store count and store profitability. When Second Cup stores deliver an outstanding experience for customers, everything falls into place. Sales and profitability grow, franchisees earn better returns, company profitability rises and growth will resume.

It is no easy task to fix a long ailing specialty retailer, but we have some important advantages. The quality of Second Cup's real estate is exceptional. The capital structure has been strengthened and there is a shared commitment to create value. To date, we have not succeeded in creating value, and alternatives will be considered if Second Cup is unable to maximize value independently.

There is a level of shared impatience among shareholders, directors and management. I regard this as healthy, as our commitment to maximize long term value is not subject to compromise.

We are grateful for your support as Second Cup pursues its journey, committed to realize its full potential success.

**Michael Bregman**

A handwritten signature in black ink, appearing to read 'Michael Bregman'. The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Chairman

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# Letter from the President & CEO

In 2016 we focused on our strategic priorities and we addressed major structural issues in the company. The related costs are largely behind us. With fewer distractions and a solid foundation, we are focused on building sales and profitability. While we are not satisfied with our performance, we are encouraged by our quarter over quarter improvement in our earnings throughout the year. We are pleased by positive same store sales growth in our largest market of Ontario, and the continued optimism and support from our franchisees.

We reduced our corporate store count from 32 at the beginning of the year to 22 by year end. We will continue to pursue opportunities to further decrease corporate stores as we return to an asset-light model.

Bringing the best coffees in the world to our customers is at the core of our brand and 2016 was a year of coffee enhancements. We took our coffee quality to even higher levels of excellence by examining and improving every step of the coffee process from farm to cup, engaging the talents of some of the world's most knowledgeable coffee aficionados. We created a new and unique blend called Batch42 that has resonated well with our customers.

The modernization of our fleet of stores continues with close to 30 new and renovated locations in Ontario, Quebec and Alberta. Each café reflects the local community while delivering on our commitment to superior quality and innovation. We continue to make enhancements to the concept. Each renovation and new store re-energizes the franchisees, their staff and customers and the overall Second Cup brand.

We aim for more aggressive growth in the next three years.

Second Cup's Rewards program, a strategic priority for the company and important business driver continued to gain members, recently achieving a key milestone of 300,000 members and 25% sales penetration in under two years.

In December we completed a successful re-financing with Serruya Private Equity, retiring our bank debt. We expect to benefit from the Serruya family as they have tremendous experience with franchised concepts.

Our top priorities for 2017 are increasing sales and profitability for both our franchisees and the company. Innovation is critical to our success. We have streamlined our approach to food and beverage innovation and are set on delivering three major sales building initiatives this year. In January we launched our *Better for You* line of healthy products including smoothies. This spring will mark the debut of Flash Cold Brew, a superior tasting cold coffee offering that will be the best in the market. We have exciting fresh food and lunch ideas in test as well.

As I have observed in past years, challenges remain and we must continue to be uncompromising in our commitment to excellence. We are seeing some encouraging signs and we remain focused on getting the business to improve. The progress we have made in improving our financial results, and the progress we have made to focus our business practices and to enhance the store experience for our customers, makes us optimistic for 2017.



The Board of Directors continues to be supportive and I thank them for their guidance and encouragement. I also want to thank our incredibly hard-working franchisees, whose dedication to our transformation has been invaluable.

Finally, I want to thank my management team, and all the support staff at Coffee Central, for the passion they bring to our business every day.

**Alix Box**

President & CEO

# Revitalizing the Network

The roll-out of the new café concept continues with close to 30 locations in the primary regions of Ontario, Alberta and Quebec. We are continuously working to evolve the builds, taking a customized approach for each location to reflect the local community while delivering on our commitment to superior quality and innovation. Each renovation and new build re-energizes the brand as well as the franchisees, their staff and customers.

# SECOND CUP COFFEE CO.™

*Proudly Operated by  
Alvaro Carbonell*

*- Since 2015 -*

# "The transformation of my café after the renovation has been dramatic – for customers, for staff, for sales!"

"It's always been a great location in a vibrant downtown community but the design was tired. The physical changes in colour and design immediately changed the vibe of the café from quiet solitude to social and energetic. The staff and regulars love coming here, it makes them happy. The contemporary design has attracted a new premium quality customer too. We're so proud of the café and excited to show it off to customers and friends. It's exactly what Second Cup needed and I'm excited about the future."

—  
Lisa Tirkalas,  
Second Cup Franchisee

*324 Bloor Street West,  
Toronto, Ontario*





# "The new café concept has completely re-energized our business, our staff and our customers."

"We are seeing significant growth in all areas of the business since last year and growth week over week. The Second Cup development team negotiated the best spot in the mall for our relocation and the new design is so eye-catching that people can't help but stop and come in. When our existing customers saw the new café they said "wow", and we've attracted many new and younger customers—the design is very appealing to everyone. The design of the café really reflects the superior quality of the brand, the products, the service, and our staff is so proud to come to work every day."

—  
Martine Desbiens & Charles Carrier,  
Second Cup Franchisees

*Fairview Pointe Claire,  
Montreal, Quebec*





# Driving Innovation

Driving innovation is fundamental to the transformation strategy. A number of key initiatives in coffee, food and Rewards were furthered in 2016 to deliver the ultimate coffee experience to customers. Second Cup has always been known for excellent coffee, and in 2016 we took our coffee obsession to even higher levels of excellence by examining and improving every step of the coffee process from farm to cup. A new premium quality breakfast program was introduced and the Rewards program experienced significant member and sales penetration growth. The advancements made in 2016 set the stage for exciting and significant sales growth opportunities in 2017.



# 2016: The Year of Coffee

We made uncompromising improvements to sourcing, blending, roasting and tasting to create truly exceptional coffees that are Second to None.

## THE BEST SOURCING

Second Cup only selects from the top 2% of the world's production of coffee – the highest quality 100% Specialty Grade Arabica beans.

## THE BEST ROASTING

Second Cup is now working with an award-winning Canadian artisanal roaster that develops and enhances the flavour notes of every bean, and every roast is tasted and tested by Second Cup Coffee Expert, Chris Sonnen.

## THE BEST PEOPLE

There is an entire team of coffee lovers behind every Second Cup coffee including two of the best Coffee Experts in the business: Alton McEwen – a long-time leader in the specialty coffee sector – and Chris Sonnen who brings an unrivalled passion for the ultimate brew to Second Cup.

## Our Coffee is Second to None

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*"I don't know where you can get a better cup of coffee than Second Cup. I've had the privilege of working with Chris Sonnen at Second Cup who has been working to ensure that Second Cup is incorporating every new advancement in sourcing, roasting and production to maximize quality."*

### **Alton McEwen**

Member of the Board,  
Second Cup

30 years of specialty coffee  
business experience, 25 years  
with Second Cup.





**OUR COFFEE IS  
SECOND TO NONE.™**

Better. Not bitter.

*Chris Sonne*

Chris Sonnen,  
Second Cup's Coffee Expert



## Batch 49<sup>™</sup>

Being a Canadian company makes us proud. We wanted to do something in a unique way that reflects our position as the only Canadian specialty coffee retailer. Early in 2016 we introduced our new signature blend – Batch49 – denoting the position of Canada on the 49th parallel.

Perfect hot or cold, we believe no other coffee comes close to it. It is unparalleled in terms of taste and quality. Our customers and franchisees loved it so much we made it a permanent coffee offering.



# Better Breakfast, Better Day



Premium quality food is an important part of the ultimate coffee experience. Eating occasions outside the home are growing and breakfast in particular is 'on the go'. Second Cup's strategic focus on premium quality food innovation advanced in 2016 with the introduction of the new breakfast program featuring a line of premium quality sandwiches including healthier choices like the egg white and spinach on naan bread. These premium quality sandwiches are made fresh through local vendors across the country. Breakfast sandwich sales doubled in 2016 and more innovation is planned for 2017.



# Rewards

One of the biggest successes in the transformation has been the Rewards program which continues to grow. In February 2017 the program achieved a key milestone reaching the 300,000 member mark and 25% sales penetration in under two years. Members enjoy free rewards faster by earning points with every dollar spent and through personalized bonus point offers sent by email and on the mobile app. Franchisees recognize the program's ability to drive incremental visits and sales. The Rewards program continues to be a strategic priority for Second Cup.

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*"The Rewards program was one of the key drivers of our significant sales growth in 2016. Customers love when they earn a free Reward; they get excited and will come back to visit more often."*

**Ed Grant, Second Cup Franchisee**

Halifax Shopping Centre, Halifax, Nova Scotia

# ReWard Yourself



**Members earn FREE coffee faster!**

# A Look at 2017

With a strong foundation set in 2016, our product and marketing innovation is focused on differentiated products with mass appeal and superior quality that have the ability to drive meaningful incremental sales. With a new test and learn approach, we will confidently and boldly roll out our new ideas.



Our franchisees are very proud of Second Cup's Canadian heritage. To celebrate Canada 150 we created a new beautifully designed cup, illustrated by world famous Canadian artist John Coburn, that reflects our community brand pillar depicting iconic Canadian landmarks and valued traditions from coast to coast.

# Better For You Menu



The first big initiative launched in January is the *Better For You* menu - a new line of *Better For You* products to meet growing customer demand for healthier options. The new menu includes smoothies made with a whole fresh banana and added benefits like flax, protein and greens and a healthy breakfast wrap with 10 grams of fat. Marketing support is focused on driving trial. We are excited by the customer adoption and franchisees are enthusiastic about our plan to continue to expand the line with innovative additions.

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*"In today's market the consumer is looking for healthier choices. Since we have introduced the Better For You products our smoothie and yogurt sales have significantly increased compared to last year. We are receiving positive feedback from our existing customers and attracting new customers. They are looking for better quality ingredients, better taste and without the calories."*

**Tom & Joanne Kastias,**  
**Second Cup Franchisees**  
Hyatt Hotel, Toronto Ontario





## Lunch Innovation.

### A CLASSIC REMASTERED – CHEESE MELTS

Lunch is the fastest growing daypart in the market and with the introduction of Cheese Melts, we have a fresh, premium quality sandwich to offer our customers. Regional roll out began in March 2017.

# ReThink the Cold.

## FLASH COLD BREW

In April, Second Cup introduces Canadians to the ultimate cold coffee experience – Flash Cold Brew. The cold coffee category is experiencing tremendous growth. With the flash brewing method and using our popular Batch<sup>49</sup> coffee, customers will enjoy full coffee flavour and a smoother taste. Brewed directly over ice, we believe the flash cold brew method delivers the best cold coffee experience – an aromatic, smoother, cleaner, brighter taste.



**“The innovation in 2016 helped us to strengthen our superior quality position in coffee and food and the Rewards program continues to drive customer loyalty and sales. I value the collaborative approach with Second Cup and know franchisees are very optimistic about the future with new product innovations like the Better for You program.”**

Steven Craig, Second Cup Franchisee and member of the Franchisee Advisory Council.



# FINANCIAL HIGHLIGHTS

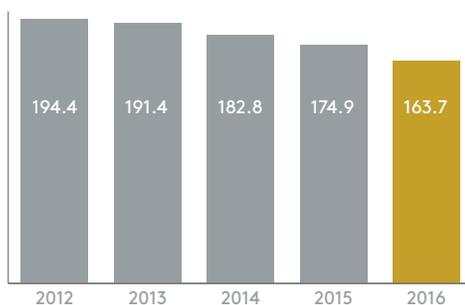
*In thousands of Canadian dollars, except number of cafés and per share amounts*

The following table sets out selected IFRS and certain non-GAAP financial measures of the Company and should be read in conjunction with the Audited Financial Statements of the Company for the 53 weeks ended December 31, 2016

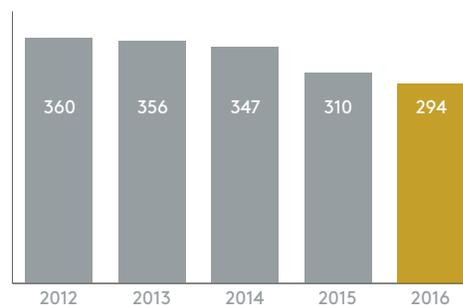
	14 weeks ended	13 weeks ended	53 weeks ended	52 weeks ended
(In thousands of Canadian dollars, except same café sales, number of cafés, per share amounts, and number of common shares.)	December 31, 2016	December 26, 2015	December 31, 2016	December 26, 2015
System sales of cafés <sup>1</sup>	\$46,743	\$46,900	\$163,738	\$174,866
Same café sales <sup>1</sup>	(1.0%)	0.2%	(1.1%)	(1.4%)
Number of cafés – end of period	294	310	294	310
Total revenue	\$7,500	\$9,636	\$30,351	\$37,341
Operating costs and expenses	\$7,199	\$9,469	\$31,336	\$38,422
Operating income (loss) <sup>1</sup>	\$301	\$167	(\$985)	(\$1,081)
EBITDA <sup>1</sup>	\$667	\$555	\$563	\$384
Net income (loss) and comprehensive income (loss)	\$147	\$94	(\$975)	(\$1,153)
Basic and diluted earnings (loss) per share as reported	\$0.01	\$0.01	(\$0.08)	(\$0.09)
Total assets – end of period	\$45,314	\$46,485	\$45,314	\$46,485
Number of weighted average common shares issued and outstanding	12,830,945	12,830,945	12,830,945	12,830,945

<sup>1</sup> See the section "Definitions and discussion on certain non-GAAP measures" for further analysis.

**System wide sales**  
(in millions of Canadian dollars)



**Number of Second Cup cafés**  
(in Canada)



# MANAGEMENT'S DISCUSSION AND ANALYSIS

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## CAUTION REGARDING FORWARD-LOOKING STATEMENTS

Certain statements in this Management's Discussion and Analysis ("MD&A") may constitute forward-looking statements within the meaning of applicable securities legislation. The terms the "Company", "Second Cup", "we", "us", or "our" refer to The Second Cup Ltd. Forward-looking statements include words such as "may", "will", "should", "expect", "anticipate", "believe", "plan", "intend" and other similar words. These statements reflect current expectations regarding future events and financial performance and speak only as of the date of this MD&A. The MD&A should not be read as a guarantee of future performance or results and will not necessarily be an accurate indication of whether or not those results will be achieved. Forward-looking statements are based on a number of assumptions and are subject to known and unknown risks, uncertainties and other factors, many of which are beyond Second Cup's control that may cause Second Cup's actual results, performance or achievements, or those of Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. The following are some of the factors that could cause actual results to differ materially from those expressed in the underlying forward-looking statements: competition; availability of premium quality coffee beans; the ability to attract qualified franchisees; the location of Second Cup cafés; the closure of Second Cup cafés; loss of key personnel; compliance with government regulations; potential litigation; the ability to exploit and protect the Second Cup trademarks; changing consumer preferences and discretionary spending patterns including, but not restricted to, the impact of weather and economic conditions on such patterns; reporting of system sales by franchisees; and the financial performance and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under "Risks and Uncertainties" below and in Second Cup's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

Although the forward-looking statements contained in this MD&A are based on what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with these forward-looking statements and, as a result, the forward-looking statements may prove to be incorrect.

As these forward-looking statements are made as of the date of this MD&A, Second Cup does not undertake to update any such forward-looking statements whether as a result of new information, future events or otherwise. Additional information about these assumptions and risks and uncertainties is contained in the Company's filings with securities regulators. These filings are also available on the Company's website at [www.secondcup.com](http://www.secondcup.com).

## INTRODUCTION

The following MD&A has been prepared as of February 24, 2017 and is intended to assist in understanding the financial performance and financial condition of The Second Cup Ltd. ("Second Cup" or the "Company") for the 14 weeks (the "Quarter") and 53 weeks (the "Year") ended December 31, 2016, and should be read in conjunction with the Audited Financial Statements of the Company, accompanying notes and the Annual Information Form, which are available at [www.sedar.com](http://www.sedar.com). Past performance may not be indicative of future performance. All amounts are presented in thousands of Canadian dollars, except number of cafés, per share amounts or unless otherwise indicated and have been prepared in accordance with International Financial Reporting Standards ("IFRS"). The Company also reports certain non-IFRS measures such as System sales of cafés, Same café sales, Free cash flow, Net debt, Loyalty sales, Operating income, and EBITDA that are discussed in the "Definitions and discussion of certain non-GAAP financial measures" in this MD&A.

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## CORE BUSINESS, STRATEGY, AND PERFORMANCE DRIVERS

### *Core business*

Second Cup is a Canadian specialty coffee retailer with 294 cafés operating under the trade name Second Cup™ in Canada, of which 22 are Company owned and the balance is operated by franchisees.

Second Cup owns the trademarks, trade names, operating procedures and systems and other intellectual property used in connection with the operation of Second Cup cafés in Canada, excluding the Territory of Nunavut.

The Company was incorporated under the Business Corporations Act (Ontario) in 2011. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The website is [www.secondcup.com](http://www.secondcup.com). The common shares are listed on the Toronto Stock Exchange under the symbol "SCU".

The fiscal year follows the method, such that each quarter will consist of 13 weeks and will end on the Saturday closest to the calendar quarter-end. The fiscal year is made up of 52 or 53-week periods ending on the last Saturday of December. Fiscal year 2016 consists of 53 weeks.

As at December 31, 2016, the issued share capital consisted of 12,830,945 common shares.

Additional information including the Annual Information Form is on SEDAR at [www.sedar.com](http://www.sedar.com).

As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business.

### ***Strategic imperatives and key performance drivers***

Second Cup's vision of being the coffee brand most passionately committed to quality and innovation will drive management's strategies and actions going forward. Coffee will be at the core of the offering and the brand will win customers' hearts through more "personalized experiences".

As the Canadian specialty coffee company, bringing the best coffees in the world to customers is at the core of the brand and fundamental to redefining Second Cup as the coffee brand most passionately committed to quality and innovation. Second Cup reinforced its position as The Canadian Specialty Coffee Company with the September 2016 launch of its Second to None coffee campaign featuring in-house Coffee Expert Chris Sonnen. The campaign showcases the significant enhancements made in every step of the coffee process from farm to cup resulting in superior coffee taste that is "better, not bitter".

The Company is encouraged by its progress in franchising corporate stores to strong operators, returning to an asset light business model, and expects to make further reductions in the number of Company-owned cafés in 2017.

## **CAPABILITIES**

This section documents factors that affect the Company's capabilities to execute strategies, manage key performance drivers and deliver results. This section is qualified by the section "Caution Regarding Forward-Looking Statements" at the beginning of this MD&A.

### ***The Second Cup brand***

In conjunction with the official unveiling of the "café of the future", the Company launched its present logo and branding in December of 2014. The updated brand — Second Cup Coffee Co.™ — reflects a new independent spirit, a commitment to deliver the world's finest coffee, and the Company's vision to be the coffee brand most passionately committed to quality and innovation. The logo is designed to convey the elevated premium status of the brand, and all touch points both inside and outside of the café have been modernized. A proud Canadian company since 1975 with 294 cafés across Canada, Second Cup Coffee Co.™ is a specialty coffee retailer. The Company maintains its commitment to the communities it operates in, celebrating the franchisees' local ownership and their focus on providing quality and friendly service to each customer in every café.

### ***The "Café of the Future"***

The new design revolves around the Company's brand pillars of superior quality, optimism, collaboration, creativity and community, and focuses on the individual customer experience. Features of the new café include a Slow Bar, where customers can interact with baristas and taste coffees made from new brewing technologies, an expanded portfolio of coffees, baked goods handcrafted in local bakeries, modern layout and architectural design, built-in charging stations for electronic devices, custom music program, community wall mural created by local artists that reflects and celebrates the neighborhood, and a stylish new employee dress code.

### ***The people***

The franchise network consists of approximately 3,500 team members. Team members range from baristas, managers and franchisees at the cafés to support personnel employed at Coffee Central (head office). Baristas and franchisees complete extensive training and certification to deliver a quality product to our customers. Franchisees and baristas are subject to operational quality checks to monitor performance.

### ***Product***

The Company has a strategic partnership with an independent roaster of coffees. The Company has also partnered with Swiss Water Decaffeinated Coffee Company Inc. to decaffeinate its coffee. This process is 100% chemical-free, unlike other decaffeination methods that use methylene chloride or ethyl acetate to remove the caffeine.

This decaffeination process gently removes 99.9% of the caffeine while maintaining the unique taste characteristics of the coffee. The process reflects Second Cup's commitment to natural and healthy products.

The coffee portfolio currently contains 19 varieties of coffee, including six single-origin and estate coffees and flavoured coffees as well as proprietary blends like Batch<sup>42</sup>, Paradiso<sup>®</sup> and Espresso Forte. The cafés offer a wide variety of handcrafted espresso-based beverages and iced and blended beverages, including espressos, cappuccinos, lattes and the popular Vanilla Bean Latte and Moccaccino. Second Cup is committed to developing and introducing new drinks, an example of which is the Flat White, an internationally popular espresso-based drink which Second Cup was the first to market nationally in Canada. The Company has a long history of partnering with coffee producers, and buying direct from farm or mill, and has Canadian exclusivity to sell San Agustin, Fazenda Vista Alegre, Cuzco<sup>®</sup> and La Minita Tarrazú; La Minita is considered by many to be the most carefully processed coffee in the world. In 2014, the Company introduced single serve capsules in a variety of roasts for at-home consumption.

Second Cup prides itself that all of its coffee and espresso beverages are certified by a third party such as Rainforest Alliance<sup>™</sup> – certification that the coffee is grown and processed in a socially and environmentally responsible manner. The Company offers a fair-trade and organic certified blend of coffee entitled Cuzco<sup>®</sup>.

In addition to coffee-based products and other beverages, cafés carry a variety of complementary products, including pastries, sandwiches, muffins, cookies, coffee accessories and coffee-related gift items.

***Liquidity, capital resources and management of capital***

The Company's objectives relating to the management of its capital structure are to:

- safeguard its ability to continue as a going concern;
- maintain financial flexibility in order to preserve its ability to meet financial obligations;
- maintain a capital structure that provides financing options to the Company when the need arises to access capital; and
- deploy capital to provide an adequate return to its shareholders.

The Company's primary uses of capital are to finance increases in non-cash working capital and capital expenditures. The Company determines the appropriate level of debt in the context of its cash flows and overall business risks. On August 5, 2014, the Company suspended its dividend in order to retain cash resources for redeployment into investments that will maximize long-term growth in share value.

On December 2, 2016, the Company replaced its credit facility with a new credit facility. The new credit facility has a face value of \$8,000, is collateralized by substantially all the assets of the Company and matures on December 2, 2020 (with no principal payments prior to December 2, 2020). Pursuant to the terms of the Company's new credit facility, the Company is subject to certain financial and other customary covenants. The Company is required to maintain certain covenants which are defined in the agreement:

- The Company shall not have negative EBITDA for (a) any trailing four fiscal quarter period (calculated quarterly) or (b) any two consecutive fiscal quarters (calculated quarterly); and
- The Company shall at all times maintain trade accounts payables average age no longer than 30% above the trade accounts payables average age as at September 30, 2016, approximately 28 days (calculated quarterly).

The Company was in compliance with these covenants at December 31, 2016. While management believes the Company will be able to comply with all of the financial covenants for the foreseeable future, there is no assurance covenants in the future will be met. Non-compliance with covenants can be remediated by additional cash injection but may also impact the Company's ability to amend covenants or renew its facility in the future.

The facility bears interest at the Base Rate, as defined in the agreement, which is set at 10.0% per annum.

In conjunction with the new credit facility, the Company granted the lender 600,000 warrants to purchase the equivalent number of common shares at a price of \$2.75. These warrants expire on December 2, 2020 and have been assigned a fair value of \$0.62 using the Black-Scholes model and have been included in the unamortized transaction costs. Key assumptions in the calculation of fair value include volatility of 41%, interest rate of 1.06% and dividend rate of nil.

### Competition

The Canadian specialty coffee market is highly competitive and highly fragmented, with few barriers to entry. There are national, regional and local coffee retailers who are specialty coffee providers or quick serve restaurants with broad menus.

### Technology

Second Cup relies heavily on information technology network infrastructure including point of sale system ("POS") hardware and software in cafés, gift and loyalty card transactions, and head office financial and administrative functions. The ability to manage operations effectively and efficiently depends on the reliability and capacity of these technology systems, most of which are administered by third party suppliers. The Company has made significant investments in POS systems across its store network as it relies on the POS system to help analysis for both marketing initiatives and royalty calculations.

## FINANCIAL HIGHLIGHTS

The following table sets out selected IFRS and certain non-GAAP financial measures of the Company and should be read in conjunction with the Audited Financial Statements of the Company for the 53 weeks ended December 31, 2016.

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Basic and diluted earnings (loss) per share as reported	\$0.01	\$0.01	(\$0.08)	(\$0.09)
Total assets – end of period	\$45,314	\$46,485	\$45,314	\$46,485
Number of weighted average common shares issued and outstanding	12,830,945	12,830,945	12,830,945	12,830,945

<sup>1</sup> See the section "Definitions and discussion on certain non-GAAP measures" for further analysis.

## OPERATIONAL REVIEW

### *Seasonality of System sales of cafés*

The following table shows the percentage of annual System sales of cafés achieved, on average, in each fiscal reporting quarter over the last three Years:

% of annual System sales of cafés	2014	2015	2016	Average
First Quarter	24.0	24.7	23.9	24.2
Second Quarter	25.1	25.0	24.6	24.9
Third Quarter	23.9	23.5	23.0	23.5
Fourth Quarter	27.0	26.8	28.5	27.4
	100.0	100.0	100.0	100.0

Historically, System sales of cafés have been higher in the fourth quarter, which includes the holiday sales periods of November and December. In 2016, Fourth Quarter contains one extra week, for a total of 14 weeks.

### *Café network*

	14 weeks ended December 31, 2016	13 weeks ended December 26, 2015	53 weeks ended December 31, 2016	52 weeks ended December 26, 2015
Number of cafés – beginning of period	298	327	310	347
Cafés opened	2	1	4	3
Cafés closed	(6)	(18)	(20)	(40)
Number of cafés – end of period	294	310	294	310

The Company ended the Year with 22 (2015 – 32) Company-owned cafés. Café closures are mainly attributable to leases that are not renewed on expiration, under-performing locations and landlord re-development of specific sites.

## Fourth Quarter

### *System sales of cafés*

System sales of cafés for the 14 weeks ended December 31, 2016 were \$46,743 compared to \$46,900 for the 13 weeks ended December 26, 2015 representing a decrease of \$157 or 0.3%. The decrease is attributable to the reduced store count and a decrease in same café sales, offset by inclusion of an extra week of sales.

### *Same café sales*

During the Quarter, same café sales decreased by 1.0%, compared to an increase of 0.2% in the comparable Quarter of 2015. Alberta's ongoing economic downturn continued to negatively impact overall same store sales by approximately 1.3% in the Quarter.

### *Analysis of revenue*

Total revenue for the Quarter was \$7,500 (2015 – \$9,636) consisting of Company-owned café and product sales, royalty revenue, franchise fees and other revenue.

Company-owned cafés and product sales for the Quarter were \$3,210 (2015 – \$5,506). The decrease in revenue of \$2,296 is attributable to the reduced Company-owned cafés count from 32 last year to 22 this Year and lower Company-branded consumer product sales, offset by inclusion of an extra week of sales. Reducing Company-owned cafés is consistent with the Company's strategy of returning to an asset light business model.

Franchise revenue was \$4,290 for the Quarter (2015 – \$4,130). The increase in franchise revenue of \$160 in 2016 is primarily driven by a slightly better blended royalty rate on higher franchise café sales due to an extra week, offset by fewer cafés.

#### ***Operating costs and expenses***

Operating costs and expenses include the costs of Company-owned cafés and product sales, franchise-related expenses, general and administrative expenses, loss/gain on disposal of assets, and depreciation and amortization. Total operating costs and expenses for the Quarter were \$7,199 (2015 – \$9,469), a decrease of \$2,270.

#### ***Company-owned cafés and product sales***

Company-owned cafés and product related expenses for the Quarter were \$3,410 (2015 – \$5,678), a decrease of \$2,268. This decrease in costs is attributable to a lower number of Company-owned cafés and lower product sales as compared to 2015.

#### ***Franchise***

The Company incurred franchise related expenses of \$2,006 (2015 – \$1,816). Expenses for the same period in 2015 benefited from an adjustment in the provisions for café closure costs.

#### ***General and administrative***

General and administrative expenses were \$1,502 for the Quarter (2015 – \$1,565). The \$63 decrease is mainly due to reduced staff-related expenses as a result of a reduction in employee headcount.

#### ***Gain and loss on disposal of assets***

A gain on disposal of \$84 was recognized in the Quarter (2015 – loss of \$22). Gain and loss on disposal of assets are primarily related to the franchising of Company-owned cafés to franchise partners.

#### ***Depreciation and amortization***

Depreciation and amortization expense was \$365 (2015 – \$388).

#### ***EBITDA***

EBITDA for the Quarter was \$667 compared to \$555 in 2015. The increase of \$112 is primarily due to a smaller loss attributed to the Company-owned cafés and product sales segment.

#### ***Net income (loss)***

The Company's net income for the Quarter was \$147 or \$0.01 per share, compared to a net income of \$94 or \$0.01 per share in 2015.

A reconciliation of net income (loss) to Adjusted EBITDA is provided in the section "Definitions and discussion of certain non-GAAP financial measures".

### **Year**

#### ***System sales of cafés***

System sales of cafés for the Year were \$163,738 compared to \$174,866 for 2015, representing a decrease of \$11,128 or 6.4%. The decrease is attributable to decreased same café sales as well as the reduced café count.

#### ***Same café sales***

For the Year, same café sales declined by 1.1% compared to a decline of 1.4% in 2015. Alberta's economic downturn continued to negatively impact overall same store sales by approximately 1.3% for the Year.

**Analysis of revenue**

This analysis of revenue includes the revenue outlined in the quarterly comments above. Total revenue for the Year was \$30,351 (2015 – \$37,341).

Company-owned cafés and product sales were \$14,663 (2015 – \$22,082). The decrease of \$7,419 is attributable to the gradual reduction in the Company-owned cafés count from 32 at the end of 2015 to 22 this Year and lower Company-branded consumer product sales, offset by inclusion of an extra week of sales. Reducing Company-owned cafés is consistent with the Company's strategy of returning to an asset light business model.

Franchise revenue was \$15,688 for the Year (2015 – \$15,259). The increase in revenue of \$429 is primarily driven by a slightly better blended royalty rate on franchise café sales and fee revenue from corporate café resales, offset by fewer franchise café count in 2016.

**Operating costs and expenses**

Operating expenses include the costs outlined in the quarterly comments above. Total operating expenses for the Year were \$31,336 (2015 – \$38,422), a decrease of \$7,086.

**Company-owned cafés and product sales**

Company-owned cafés and product related expenses for the Year were \$15,682 (2015 – \$22,382), a decrease of \$6,700. The decrease in costs is mainly related to lower café operating expenses associated with the reduction of Company-owned cafés.

**Franchise**

Franchise related expenses of \$8,103 were incurred for the Year (2015 – \$8,809). The decrease of \$706 is attributable to rent-related expenses recorded during the third quarter of 2015.

**General and administrative**

General and administrative expenses were \$5,778 for the Year (2015 – \$5,787). Restructuring and severance costs were lower in the Year offset by an increase in technology costs as compared to 2015.

**Gain and loss on disposal of assets**

A loss on disposal of assets of \$225 was recognized for the Year (2015 – \$21 gain). The loss is related to the resale of Company-owned cafés.

**Depreciation and amortization**

Depreciation and amortization expense was \$1,548 (2015 – \$1,465).

**EBITDA**

EBITDA for the Year was \$563, compared to \$384 last year. The increase in 2016 over 2015 is mainly due to the improvement in the franchise business partially offset by lower earnings from Company-branded product sales.

**Net loss**

The Company's net loss for the Year was \$975 or \$0.08 loss per share, compared to a net loss of \$1,153 or \$0.09 loss per share in 2015.

A reconciliation of net loss to adjusted EBITDA is provided in the section "Definitions and discussion of certain non-GAAP financial measures".

## SELECTED QUARTERLY INFORMATION

(in thousands of Canadian dollars, except Number of cafés, Same café sales, and per share amounts)	Q4 2016 <sup>2</sup>	Q3 2016	Q2 2016	Q1 2016
System sales of cafés <sup>1</sup>	\$46,743	\$37,717	\$40,207	\$39,071
Same café sales <sup>1</sup>	(1.0%)	(1.2%)	(1.3%)	(1.1%)
Number of cafés – end of period	294	298	304	307
Total revenue	\$7,500	\$7,656	\$7,761	\$7,434
Operating income (loss) <sup>1</sup>	\$301	(\$25)	(\$528)	(\$733)
EBITDA <sup>1</sup>	\$667	\$357	(\$128)	(\$332)
Net income (loss) for the period	\$147	(\$75)	(\$441)	(\$606)
Basic and diluted earnings (loss) per share	\$0.01	(\$0.01)	(\$0.03)	(\$0.05)
Dividends declared per share	–	–	–	–
	Q4 2015 <sup>2</sup>	Q3 2015	Q2 2015	Q1 2015
System sales of cafés <sup>1</sup>	\$46,900	\$41,087	\$43,715	\$43,174
Same café sales <sup>1</sup>	0.2%	(2.9%)	(3.2%)	(1.1%)
Number of cafés – end of period	310	327	339	344
Total revenue	\$9,636	\$9,270	\$9,421	\$9,014
Operating (loss) income <sup>1</sup>	\$167	(\$1,310)	(\$6)	\$68
EBITDA <sup>1</sup>	\$554	(\$924)	\$334	\$419
Net (loss) income for the period	\$94	(\$1,099)	(\$72)	(\$76)
Basic and diluted (loss) earnings per share	\$0.01	(\$0.09)	(\$0.01)	(\$0.01)
Dividends declared per share	–	–	–	–

1 See the section “Definitions and discussion on certain non-GAAP financial measures” for further analysis.

2 The Company’s fourth quarter System sales of cafés are higher than other quarters due to the seasonality of the business (see “Seasonality of system sales of cafés” above).

## LIQUIDITY AND CAPITAL RESOURCES

Second Cup collects royalties based on the franchisees’ portion of System sales of cafés, franchise fees, and other amounts from its franchisees and also generates revenues from its Company-owned cafés. The performance of Second Cup franchisees and Company-owned cafés could impact the ability of the Company to declare and pay dividends to its shareholders. For a more detailed discussion of the risks and uncertainties affecting the Company’s liquidity, see the “Risks and uncertainties” section below.

### Summary of cash flows

	14 weeks ended	13 weeks ended	53 weeks ended	52 weeks ended
	December 31, 2016	December 26, 2015	December 31, 2016	December 26, 2015
Cash flows provided by (used in) operating activities	(\$479)	(\$722)	(\$1,253)	(\$675)
Cash flows provided by (used in) investing activities	(19)	(940)	(365)	(2,093)
Cash flows provided by (used in) financing activities	1,542	(5,070)	1,542	(5,070)
Increase (decrease) in cash and cash equivalents during the period	\$1,044	(\$6,732)	(\$76)	(\$7,838)

#### Fourth Quarter

Cash used in operating activities was \$479 for the Quarter compared to cash used of \$722 for the same Quarter in 2015. The reduction in cash use of \$243 is primarily due to a smaller change in the Co-op Fund offset by gains in disposal of capital assets.

During the Quarter, cash used in investing activities was \$19 compared to cash used of \$940 for the same Quarter in 2015 due to lower payments for capital expenditures and intangible assets in 2016.

Cash generated in financing activities was \$1,542 (2015 – cash used of \$5,070). The increase in cash provided of \$6,612 was due to the repayment of \$5,000 of the term loan in 2015 and the increase in long-term debt of \$2,000, offset by financing charges.

#### Year

Cash used by operating activities was \$1,253 for the Year compared to cash use of \$675 for 2015. The increase in cash used of \$578 was primarily caused by a reduction in accounts payable and accrued liabilities, offset by losses in disposal of capital assets.

During the Year, cash used in investing activities was \$365 compared to cash used of \$2,093 for 2015. The reduction in cash used was primarily the result of lower capital expenditures and payments for intangible assets in 2016.

Financing activities resulted in a cash generation of \$1,542 (2015 – cash used of \$5,070). The increase in cash of \$6,612 was due to the repayment of \$5,000 of the term loan in 2015 and the increase in long-term debt of \$2,000, offset by financing charges, as a result of replacing the credit facility with the new facility described in the "Liquidity, capital resources and management of capital" section.

#### Working capital as at

	December 31, 2016	December 26, 2015
Current assets	\$9,096	\$8,817
Current liabilities	10,242	11,804
Working capital deficiency	(\$1,146)	(\$2,987)

The Company's working capital deficit of \$1,146 as at December 31, 2016 improved by \$1,841 from December 26, 2015, primarily as a result of a reduction in accounts payable and accrued liabilities at the end of 2016. Gift card liability ended the Year at \$3,484, a decrease of \$70 compared to the end of 2015. Based on the historical redemption patterns, the Company believes that it has sufficient financial resources to cover the gift card liability. The Company operates in the franchise industry, in which a working capital deficit is considered normal.

The Company had cash and cash equivalents of \$3,004 as at December 31, 2016 (December 26, 2015 – \$3,080) and recently replaced its credit facility which does not require principal payments until 2020. The Company continues to believe it has sufficient financial resources to meet its obligations as they come due.

### **Financial instruments**

The following summarizes the nature of certain risks applicable to the Company's financial instruments:

<b>Financial instrument</b>	<b>Risks</b>
<b>Financial assets</b>	
Cash and cash equivalents	Credit and interest rate
Restricted cash	Credit and interest rate
Trade and other receivables	Credit
Notes and leases receivable	Credit
<b>Financial liabilities</b>	
Interest rate swap	Credit, liquidity and interest rate
Accounts payable and accrued liabilities	Liquidity, currency and commodity
Gift card liability	Liquidity
Deposits from franchisees	Liquidity
Term loan	Liquidity and interest rate

#### **(i) Credit risk**

##### **Cash and cash equivalents, restricted cash and interest rate swap**

Credit risk associated with cash and cash equivalents, restricted cash and the interest rate swap is managed by ensuring these assets are placed with institutions of high creditworthiness.

##### **Trade and other receivables, and notes and leases receivable**

Trade and other receivables, and notes and leases receivable primarily comprise amounts due from franchisees. Credit risk associated with these receivables is mitigated as a result of the review and evaluation of franchisee account balances beyond a particular age. Prior to accepting a franchisee, the Company undertakes a detailed screening process, which includes the requirement that a franchisee have sufficient capital and financing. The risk is further mitigated due to a broad franchisee base that is spread across the country, which limits the concentration of credit risk.

Other receivables may include amounts owing from large organizations where often those organizations have a simultaneous vendor relationship with the Company's franchisees. Credit risk is mitigated as a result of the Company directing and maintaining certain controls over the vendor relationship with the franchisees.

#### **(ii) Liquidity risk**

Liquidity risk is managed through regular monitoring of forecasts and actual cash flows, monitoring maturity dates of financial assets and liabilities, and also the management of capital structure and debt covenants as outlined above. The main source of income is royalty receipts from franchisees.

#### **(iii) Interest rate risk**

Financial instruments exposed to interest rate risk earn and bear interest at floating rates. The Company entered into an interest rate swap agreement to minimize risk on its long-term debt. The swap agreement expired in the third quarter of 2016. The option of entering into an interest rate swap agreement is available to the Company, as needed.

#### **(iv) Currency and commodity risk**

Transactions occur with a small number of vendors that operate in foreign currencies. The Company believes that due to low volumes of transactions, low number of vendors, and low magnitude of spend, the impact of currency risk is not material.

The Company is directly and indirectly exposed to changes in coffee commodity prices given it is a material input for the Company's product offerings. The direct exposure is mitigated given the ability to adjust its sales price as commodity prices change. Risk is mitigated by entering fixed price forward purchase commitments and by adjusting selling prices.

#### **Contingencies, commitments and guarantees**

Contractual Obligations	Total	Payments Due by Period			
		1 year	2 – 3 years	4 – 5 years	After 5 years
Debt	\$8,000	\$Nil	\$Nil	\$8,000	\$Nil
Obligations from Operating Leases	13,903	1,999	3,895	3,131	4,878
Purchase Obligations	1,382	1,382	Nil	Nil	Nil
Total Contractual Obligations	\$23,285	\$3,381	\$3,895	\$11,131	\$4,878

#### **Debt**

On December 2, 2016, the Company entered into a new credit facility which replaced its facility with the Bank of Nova Scotia. The new credit facility of \$8,000 matures on December 2, 2020 (with no principal payments prior to December 2, 2020). As part of the agreement, the Company issued 600,000 warrants that granted the lender the right to purchase in respect of each warrant one Common Share, at a purchase price of \$2.75 per Common Share, at any time up to December 2, 2020.

#### **Obligations from Operating Leases**

Second Cup has lease commitments for Company-owned cafés and also acts as the head tenant on most leases, which in turn it subleases to franchisees. To the extent the Company may be required to make rent payments due to head lease commitments, a provision has been recognized.

	Head lease commitments	Sublease to franchisees	Net
December 30, 2017	\$17,792	\$15,793	\$1,999
December 29, 2018	15,960	13,970	1,990
December 28, 2019	13,994	12,089	1,905
December 26, 2020	11,584	9,927	1,657
December 25, 2021	9,822	8,348	1,474
Thereafter	27,423	22,545	4,878
	\$96,575	\$82,672	\$13,903

The Company believes it has sufficient resources to meet the net commitment of \$13,903 over the term of the leases.

#### **Purchase Obligations**

Contracts are in place with third party companies to purchase the coffee that is sold in all cafés. In terms of these supply agreements, there is a guaranteed minimum value of coffee purchases of \$849 USD (2015 – \$2,464 USD) for the 12 months. The coffee purchase commitment comprises three components: unapplied futures commitment contracts, fixed price physical contracts and flat price physical contracts.

Due to the Company acting as the primary coordinator of café construction costs on behalf its franchisees and for Company-owned cafés, there is \$241 (2015 – \$265) of contractual commitments pertaining to construction costs for new locations and renovations as at the end of the fiscal Year. Construction costs financed for franchise projects are from deposits received from franchisees and for corporate projects from the Company's cash flows.

### ***Other Obligations***

The Company is involved in litigation and other claims arising in the normal course of business. Judgment must be used to determine whether or not a claim has any merit, the amount of the claim and whether to record a provision, which is dependent on the potential success of the claim. It is believed that no significant losses or expenses will be incurred with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time, and adjustments, if any, will be recorded in the period of settlement.

### ***Related parties***

Related parties are identified as key management, members of the Board of Directors, and shareholders that effectively exercise significant influence on the Company. Such related parties include any entities acting with or on behalf of the aforementioned parties.

## **EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

The Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”) must acknowledge they are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting (“ICFR”) for the Company. The control framework used by the CEO and CFO to design the Company’s ICFR is Internal Control over Financial Reporting – Guidance for Smaller Public Companies as issued by COSO. In addition, in respect of:

### ***Disclosure controls and procedures***

The CEO and CFO must certify they have designed the disclosure controls and procedures, or caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company is made known to them in a timely manner and that information required under securities legislation is recorded, processed, summarized and reported in a timely manner.

As at February 24, 2017, the Company’s management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the disclosure controls and procedures. Based on this evaluation, the CEO and CFO have concluded that, as at December 31, 2016, the Company’s disclosure controls and procedures were appropriately designed.

Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company’s disclosure controls and procedures can only provide reasonable, and not absolute, assurance that the objectives of such controls and procedures are met.

During the 14 weeks ended December 31, 2016 and up to the date of the approval of the Audited Financial Statements and MD&A, there has been no change that has materially affected, or is reasonably likely to materially affect the Company’s disclosure controls and procedures.

### ***Internal controls over financial reporting***

The CEO and CFO must certify they have designed such internal controls over financial reporting, or caused them to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Unaudited Condensed Interim Financial Statements for external purposes in accordance with IFRS.

As at February 24, 2017, the Company’s management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the controls over financial reporting. No material weaknesses in the design of these controls over financial reporting were identified. Based on this evaluation, the CEO and CFO have concluded that, as at December 31, 2016, the Company’s controls over financial reporting were appropriately designed and were operating effectively.

Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls should not exceed their expected benefits. As such, the Company's internal controls over financial reporting can only provide reasonable, and not absolute, assurance that the objectives of such controls are met.

During the 14 weeks ended December 31, 2016 and up to the date of the approval of the Audited Financial Statements and MD&A, there has been no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect the Company's internal control over financial reporting.

### CRITICAL ACCOUNTING ESTIMATES

The preparation of the Audited Financial Statements requires management to make estimates, assumptions, and use judgement in applying its accounting policies and estimates and assumptions about the future. Estimates and other judgements are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. The accounting estimates will, by definition, seldom equal the related actual results.

#### *Estimates*

The following are examples of estimates and assumptions the Company makes:

- the recoverability of tangible and intangible assets subject to depreciation, amortization, or with indefinite lives;
- the derivation of income tax assets and liabilities;
- the estimated useful lives of assets;
- café lease provisions and restructuring charges; and
- the allowance for doubtful accounts.

#### *Use of judgement*

The following discusses the most significant accounting judgements and estimates that the Company has made in the preparation of the Audited Financial Statements:

##### *(i) Impairment charges*

Management is required to use judgment in determining the grouping of assets to identify their cash generating units ("CGUs") for the purposes of testing intangible assets and property and equipment for impairment. In addition, management uses judgment to determine whether a triggering event has occurred requiring an impairment test to be completed. In determining the net recoverable amount of a CGU, the Company uses a fair value less costs to sell model using assumptions such as projected future sales, earnings, capital investments and discount rates. These assumptions are highly uncertain at the time the estimate is made. Changing the assumptions selected by management, in particular the discount rate and the growth rate assumptions used in the cash flow projections, could significantly affect the impairment evaluations and recoverable amounts. Projected future sales and earnings are consistent with the strategic plans provided to and approved by the Company's Board of Directors.

##### *(ii) Deferred income taxes*

The timing of reversal of temporary differences and the expected income allocation to various tax jurisdictions within Canada affect the effective income tax rate used to compute the deferred income taxes. Management estimates the reversals and income allocation based on historical and budgeted operating results and income tax laws existing at the Statements of Financial Position dates. In addition, management occasionally estimates the current or future deductibility of certain expenditures, affecting current or deferred income tax balances and expenses.

***(iii) Estimated useful lives***

Estimates for the useful lives of property and equipment are based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for depreciation of property and equipment for any period are affected by these estimated useful lives. It is possible that changes in these factors may cause significant changes in the estimated useful lives of property and equipment in the future.

***(iv) Café lease provisions***

Café lease provisions require judgement to evaluate the likelihood and measurement of settlements, temporary payouts or subleasing. Management works with landlords and franchises and uses previous experience to obtain adequate information needed to make applicable judgements.

***(v) Allowance for doubtful accounts***

The allowance for impairment of trade and other receivables is established when there is objective evidence that the Company will not be able to collect all amount due according to the original terms of the receivable. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognized in expenses in the statement of income. When an account is deemed uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are recognized as a recovery in expenses in the statement of income.

## **RISKS AND UNCERTAINTIES**

This section is qualified by the section “Caution Regarding Forward-Looking Statements” at the beginning of this MD&A.

The performance of Second Cup is primarily dependent on its ability to maintain and increase the sales of existing cafés, add new profitable cafés to the network and redevelop and modernize cafés as their leases come due. System sales of the café network are affected by various external factors that can affect the specialty coffee industry as a whole. Potential risks include the following:

The specialty coffee industry is characterized by intense competition with respect to price, location, coffee and food quality, and numerous factors affecting discretionary consumer spending. Competitors include national and regional chains, independent cafés, all restaurants and food service outlets that serve coffee, and supermarkets that compete in the whole bean and roast and ground segments.

Growth of the café network depends on Second Cup’s ability to secure and build desirable locations and find high calibre, qualified franchisees to operate them. Credit markets may affect the ability of franchisees to obtain new credit or refinance existing credit on economically reasonable terms.

Second Cup faces competition for café locations and franchisees from its competitors and from franchisors and operators of other businesses. The success of franchisees is significantly influenced by the location of their cafés. There can be no assurance that current café locations will continue to be attractive, or that additional café sites can be located and secured as demographic and traffic patterns change. Also, there is no guarantee that the property leases in respect of the cafés will be renewed or suitable alternative locations will be obtained and, in such event, cafés could be closed. It is possible that the current locations or economic conditions where cafés are located could decline in the future, resulting in reduced sales in those locations. There is no assurance that future sites will produce the same results as past sites. There is also no assurance that a franchisee will continue to pay rental obligations in a timely manner, which could result in Second Cup being obligated to pay the rental obligations pursuant to its head lease commitment, which would adversely affect the profitability of the business.

The Canadian specialty coffee industry is also affected by changes in discretionary spending patterns, which are in turn dependent on consumer confidence, disposable consumer income and general economic conditions. Factors such as changes in general economic conditions, recessionary or inflationary trends, job security and unemployment, equity market levels, consumer credit availability and overall consumer confidence levels may affect their business. The specialty coffee industry is also affected by demographic trends, traffic and weather patterns, as well as competing cafés.

Business could be adversely affected by increased concerns about food safety in general or other unusual events. On May 28, 2015, the government of Ontario enacted the Making Healthy Choices Act, 2015. The Act came into force on January 1, 2017. Restaurant chains and other food service providers with 20 or more locations operating under the same (or substantially the same) name in Ontario have made changes to the information they display on menus, menu boards and displays. The potential impact of this legislation is undetermined.

Partnerships to distribute whole bean and roast and ground coffees requires significant investments of non-refundable listing fees. The TASSIMO self-serve product has achieved positive results and the Company will continue to evaluate this area of potential growth, including consideration of adding additional products. The Company also offers whole bean and ground coffees as a complementary but different product line in comparison to self-serve.

Second Cup relies heavily on information technology (IT) network infrastructure. The ability to manage operations effectively and efficiently depends on the reliability and capacity of these IT systems, most of which are administered by third party suppliers. The Company relies on POS for system sales for both marketing trends and royalty calculations. Cafés rely on IT network infrastructure to order goods and process credit, debit and café card transactions. Coffee Central financial and administrative functions rely on IT infrastructure for accurate and reliable information. The failure of these systems to operate effectively, or problems with upgrading or replacing systems, could cause a material negative financial result. The Company is continually reviewing its systems and procedures to minimize risk.

The company's cash flow can also be impacted by underperformance of its franchise network through reduced royalties, higher lease exit provisions or the increase in the number of corporate stores. Reduced earnings could impact the company's ability to comply with its credit facility covenants.

The loss of key personnel and/or a shortage of experienced management and hourly employees could have an adverse impact on operations and cafés.

A more detailed discussion of the risks and uncertainties affecting Second Cup is set out in the Second Cup's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

## OUTLOOK

This section is qualified by the section "Caution Regarding Forward-Looking Statements" at the beginning of this MD&A.

The Company celebrated a key milestone in February 2017 with the Rewards program reaching the 300,000 member mark and 25% sales penetration in under two years. Members enjoy free rewards faster by earning points with every dollar spent and through personalized bonus point offers sent by email and on the mobile app. The Rewards program continues to be a strategic priority for the Company.

The Company has a number of new initiatives in test markets that have encouraging results for sales growth. Based on successful test market results, the Company recently launched a new line of "Better For You" products to meet growing customer demand for healthier options.

## DEFINITIONS AND DISCUSSION ON CERTAIN NON-GAAP FINANCIAL MEASURES

In this MD&A, the Company reports certain non-IFRS measures such as system sales of cafés, same café sales, free cash flows, net debt, loyalty sales, operating income (loss), EBITDA, adjusted EBITDA and adjusted earnings per share. Non-GAAP measures are not defined under IFRS and are not necessarily comparable to similarly titled measures reported by other issuers.

### ***System sales of cafés***

System sales of cafés comprise the net revenue reported to Second Cup by franchisees of Second Cup cafés and by Company-owned cafés. This measure is useful in assessing the operating performance of the entire Company network, such as capturing the net change of the overall café network.

Changes in system sales of cafés result from the number of cafés and same café sales (as described below). The primary factors influencing the number of cafés within the network include the availability of quality locations and the availability of qualified franchisees.

### ***Same café sales***

Same café sales represent the percentage change, on average, in sales at cafés operating system-wide that have been open for more than 12 months. It is one of the key metrics the Company uses to assess its performance as an indicator of appeal to customers. Two principal factors that affect same café sales are changes in customer count and changes in average transaction size.

### ***Free cash flow***

Free cash flow is calculated as operating cash flow minus capital expenditures. Free cash flow represents the cash that a company is able to generate after spending the money required to maintain or expand its asset base. Free cash flow is important because it allows the Company to pursue opportunities that enhance shareholder value.

### ***Net Debt***

Net debt refers to the total debt of the Company minus cash and cash equivalents. It does not include cash classified as restricted. Net debt is discussed at times as management believes it is a useful indicator of the Company's ability to meet debt service and evaluate liquidity.

### ***Loyalty Sales***

Loyalty sales refers to system sales that are transacted in café through or in association with the Company's loyalty program. Loyalty sales are defined as sales transactions through the Company's loyalty app or sales transactions that are accompanied by the Company's loyalty card. Management views this as useful indicator of its loyal customer base.

### ***Operating income (loss)***

Operating income (loss) represents revenue, less cost of goods sold, less operating expenses, and less impairment charges. This measure is not defined under IFRS, although the measure is derived from input figures in accordance with IFRS. Management views this as an indicator of financial performance that excludes costs pertaining to interest and financing, and income taxes.

### ***EBITDA***

EBITDA represents earnings before interest, taxes, depreciation and amortization. As there is no generally accepted method of calculating EBITDA, this measure is not necessarily comparable to similarly titled measures reported by other issuers. EBITDA is presented as management believes it is a useful indicator of the Company's ability to meet debt service and capital expenditure requirements, and evaluate liquidity. Management interprets trends in EBITDA as an indicator of relative financial performance. EBITDA should not be considered by an investor as an alternative to net income or cash flows as determined in accordance with IFRS.

A reconciliation of net income (loss) to EBITDA is provided below:

	14 weeks ended	13 weeks ended	53 weeks ended	52 weeks ended
	December 31, 2016	December 26, 2015	December 31, 2016	December 26, 2015
Net income (loss)	\$147	\$ 94	(\$975)	(\$1,153)
Interest and financing	96	72	255	457
Income taxes (recovery)	59	–	(265)	(385)
Depreciation of property and equipment	268	284	1,145	1,091
Amortization of intangible assets	97	104	403	374
EBITDA	\$667	\$554	\$563	\$384

*Basic and diluted earnings per share*

	14 weeks ended	13 weeks ended	53 weeks ended	52 weeks ended
	December 31, 2016	December 26, 2015	December 31, 2016	December 26, 2015
Net income (loss)	\$147	\$94	(\$975)	(\$1,153)
Weighted average number of shares issued and outstanding (unrounded)	12,830,945	12,830,945	12,830,945	12,830,945
Basic and diluted earnings (loss) per share	\$0.01	\$0.01	(\$0.08)	(\$0.09)

For the 14 and 53 weeks ended December 31, 2016, there were 670,000 outstanding share option awards (13 and 52 weeks ended December 26, 2015 – 715,000) and 600,000 warrants to purchase shares that are excluded due to anti-dilutive impact.

# AUDITED FINANCIAL STATEMENTS

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For the 53 weeks ended December 31, 2016 and 52 weeks ended December 26, 2015

## INDEPENDENT AUDITOR'S REPORT

February 24, 2017

To the Shareholders of  
The Second Cup Ltd.

We have audited the accompanying financial statements of The Second Cup Ltd., which comprise the statements of financial position as at December 31, 2016 and December 26, 2015 and the statements of operations and comprehensive loss, statements of changes in shareholders' equity and statements of cash flows for the fifty-three and fifty-two week periods then ended, respectively, and the related notes, which comprise a summary of significant accounting policies and other explanatory information.

### **Management's responsibility for the financial statements**

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards (IFRS), and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

### **Auditor's responsibility**

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained in our audits is sufficient and appropriate to provide a basis for our audit opinion.

### **Opinion**

In our opinion, the financial statements present fairly, in all material respects, the financial position of The Second Cup Ltd. as at December 31, 2016 and December 26, 2015 and its financial performance and its cash flows for the fifty-three and fifty-two week periods then ended, respectively, in accordance with International Financial Reporting Standards.

*PricewaterhouseCoopers LLP*

Chartered Professional Accountants, Licensed Public Accountants

## STATEMENTS OF FINANCIAL POSITION

As at December 31, 2016 and December 26, 2015

(Expressed in thousands of Canadian dollars)

	2016	2015
<b>ASSETS</b>		
<b>Current assets</b>		
Cash and cash equivalents	\$3,004	\$3,080
Restricted cash (note 22)	1,947	840
Trade and other receivables (note 6)	3,023	3,434
Notes and leases receivable (note 7)	139	120
Inventories (note 8)	200	229
Prepaid expenses and other assets	251	427
Income tax receivable	532	687
	<b>9,096</b>	<b>8,817</b>
<b>Non-current assets</b>		
Notes and leases receivable (note 7)	173	268
Property and equipment (note 9)	3,434	4,761
Intangible assets (note 10)	32,611	32,639
<b>Total assets</b>	<b>\$45,314</b>	<b>\$46,485</b>
<b>LIABILITIES</b>		
<b>Current liabilities</b>		
Accounts payable and accrued liabilities (note 11)	\$3,700	\$5,360
Provisions (note 12)	1,598	1,655
Other liabilities (note 13)	217	534
Gift card liability	3,484	3,554
Deposits from franchisees	1,243	701
	<b>10,242</b>	<b>11,804</b>
<b>Non-current liabilities</b>		
Provisions (note 12)	530	982
Other liabilities (note 13)	267	314
Long-term debt (note 14)	7,181	5,977
Deferred income taxes (note 19)	3,818	3,481
<b>Total liabilities</b>	<b>22,038</b>	<b>22,558</b>
<b>SHAREHOLDERS' EQUITY</b>	<b>23,276</b>	<b>23,927</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$45,314</b>	<b>\$46,485</b>

Contingencies, commitments and guarantees (note 23)  
See accompanying notes to financial statements.

Approved by the Directors February 24, 2017



Michael Bregman, Director



Rael Merson, Director

## STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

For the periods ended December 31, 2016 and December 26, 2015

(Expressed in thousands of Canadian dollars, except per share amounts)

	2016	2015
<b>Revenue (note 15)</b>		
Company-owned cafés and product sales	\$14,663	\$22,082
Franchise revenue	15,688	15,259
	30,351	37,341
<b>Operating costs and expenses (note 16)</b>		
Company-owned cafés and cost of product sales	15,681	22,382
Franchise	8,103	8,809
General and administrative	5,779	5,787
Loss (gain) on disposal of assets	225	(21)
Depreciation and amortization	1,548	1,465
	31,336	38,422
<b>Loss from operations</b>	(985)	(1,081)
Interest and financing (note 18)	255	457
<b>Loss before income taxes</b>	(1,240)	(1,538)
Recovery of income taxes (note 19)	(265)	(385)
<b>Net loss and comprehensive loss for the period</b>	(\$975)	(\$1,153)
<b>Basic and diluted loss per share (note 20)</b>	(\$0.08)	(\$0.09)

See accompanying notes to financial statements.

## STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

For the periods ended December 31, 2016 and December 26, 2015

(Expressed in thousands of Canadian dollars)

	Share Capital	Warrants	Contributed Surplus	Retained Earnings (Deficit)	Total
<b>Balance – December 27, 2014</b>	\$8,652	\$–	\$61,650	(\$45,308)	\$24,994
Net loss for the period	–	–	–	(1,153)	(1,153)
Stock option plan expense (note 24)	–	–	86	–	86
<b>Balance – December 26, 2015</b>	\$8,652	\$–	\$61,736	(\$46,461)	\$23,927
Net loss for the period	–	–	–	(975)	(975)
Stock option plan expense (note 24)	–	–	53	–	53
Issuance of warrants (note 14)	–	271	–	–	271
<b>Balance – December 31, 2016</b>	\$8,652	\$271	\$61,789	(\$47,436)	\$23,276

See accompanying notes to financial statements.

## STATEMENTS OF CASH FLOWS

For the periods ended December 31, 2016 and December 26, 2015

(Expressed in thousands of Canadian dollars)

	2016	2015
<b>CASH PROVIDED BY (USED IN)</b>		
<b>Operating activities</b>		
Net loss for the period	(\$975)	(\$1,153)
Items not involving cash		
Depreciation of property and equipment	1,168	1,091
Amortization of intangible assets	403	374
Share-based compensation expense	53	86
Deferred income taxes (note 19)	238	211
Loss (gain) on disposal of capital related items	225	(21)
Change in fair value of interest rate swap (note 5)	(77)	4
Changes in non-cash working capital & other (note 21)	(2,288)	(1,177)
Cash used in (provided by) operating activities	(1,253)	(585)
<b>Investing activities</b>		
Proceeds from disposal of capital related items	334	497
Cash payments for capital expenditures (note 21)	(382)	(1,942)
Cash payments for intangible assets (note 21)	(393)	(733)
Notes receivable repayment (issuance)	76	(5)
Cash used in investing activities	(365)	(2,183)
<b>Financing activities</b>		
Repayment of term loan (note 14)	(6,000)	(5,000)
Repayment of swap (note 5)	–	(70)
Proceeds from new term loan	8,000	–
Transaction costs	(458)	–
Cash provided by (used in) financing activities	1,542	(5,070)
<b>Increase (decrease) in cash and cash equivalents during the period</b>	<b>(76)</b>	<b>(7,838)</b>
<b>Cash and cash equivalents – Beginning of the period</b>	<b>3,080</b>	<b>10,918</b>
<b>Cash and cash equivalents – End of the period</b>	<b>\$3,004</b>	<b>\$3,080</b>

See accompanying notes to financial statements. Supplemental cash flow information is provided in note 21. Information on non-cash transactions and supplemental cash flow information are described further in notes 5, 14 and 21, respectively.

## NOTES TO THE FINANCIAL STATEMENTS

*For the periods ended December 31, 2016 and December 26, 2015*

(Expressed in thousands of Canadian dollars, except per share amounts)

### 1. ORGANIZATION AND NATURE OF BUSINESS

The Second Cup Ltd. ("Second Cup" or "the Company") is a Canadian specialty coffee retailer with 294 (2015 – 310) cafés operating under the trade name Second Cup™ in Canada, of which 22 (2015 – 32) are Company-operated and the balance operated by franchisees.

The Company owns the trademarks, trade names, operating procedures, systems and other intellectual property used in connection with the operation of Second Cup cafés in Canada.

The Company was incorporated under the Business Corporations Act (Ontario) in 2011 and is domiciled in Canada. The address of its registered office and principal place of business is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The Company hereafter refers to its head office activities as "Coffee Central". The Company's website is [www.secondcup.com](http://www.secondcup.com). The common shares of the Company are listed on the Toronto Stock Exchange under the symbol "SCU".

### 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### a. Basis of preparation

The financial statements (the "financial statements") have been prepared in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board ("IASB"). The financial statements have been prepared on the historical cost basis except for certain financial instruments that are measured at fair values at the end of each reporting period. The Company's functional currency is the Canadian dollar.

The Company's fiscal year follows the method implemented by many retail entities, such that each quarter will consist of 13 weeks and will end on the Saturday closest to the calendar quarter end. The fiscal year is made up of 52 or 53-week periods ending on the last Saturday of December. Fiscal 2016 is a 53-week period (2015 – 52 weeks).

The Company manages an advertising and co-operative fund (the "Co-op Fund") established to collect and administer funds contributed for use in advertising and promotional programs, and initiatives designed to increase sales and enhance the reputation of the Second Cup brand. Contributions to the Co-op Fund are required to be made from both franchised and Company-operated cafés and are based on a percentage of café sales. The revenue, expenses and cash flows of the Co-op Fund are not consolidated, but are netted on the Statement of Financial Position in accounts payable if there is a surplus, or in accounts receivable if there is a deficit to the extent that the Company will recover the deficit from franchisees. The assets and liabilities of the Co-op Fund are included in the assets and liabilities of the Company on the Statements of Financial Position. The policy is established because the contributions to the Co-op Fund are segregated, designated for a specific purpose and the Company is acting as an agent. Since the decisions as to the content and nature of the marketing campaigns are made solely by a body made up of six franchisees elected by their peers and includes representation from each region of our network (the "Advisory Council") and fulfilled by third parties, the Company does not have the primary responsibility for completing marketing campaigns using the Co-op Fund contributions provided by each franchisee.

## b. Segmented information and reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the Chief Executive Officer. The Company substantially operates and is managed as one reportable segment. Operating revenues are comprised of royalties, the sale of goods from Company-operated cafes, the sale of goods through retail and other ancillary channels, and other service fees.

Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

## c. Critical accounting estimates, assumptions and the use of judgement

The preparation of financial statements requires management to make estimates, assumptions, and use judgement in applying its accounting policies and in determining estimates and assumptions about the future. Estimates and other judgements are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected. The accounting estimates will, by definition, seldom equal the related actual results.

### Estimates

The following are examples of critical estimates, assumptions and judgements the Company makes in determining the amounts reported in the financial statements:

- the determination of the recoverable amounts of tangible and intangible assets subject to depreciation, amortization, or with indefinite lives;
- the derivation of income tax assets and liabilities;
- the estimated useful lives of assets;
- café lease provisions and restructuring charges; and
- the allowance for doubtful accounts.

### Use of judgement

The following discusses the critical judgements and accounting estimates that the Company has made in the preparation of the financial statements:

#### *(i) Impairment charges*

Impairment analysis is an area involving management judgement in determining the recoverable amount of an asset. The recoverable amount of a cash generating unit ("CGU") is calculated as the higher of the fair value less costs of disposal, and its value in use. Fair value is determined by estimating the net present value of future cash flows derived from such assets using cash flow projections that have been discounted at an appropriate rate and based on a market participant's view. In calculating the net present value of the future cash flows, certain assumptions are required to be made in respect of highly uncertain matters including:

- growth in total revenue;
- change and timing of cash flows such as the increase or decrease of expenditures;
- selection of discount rates to reflect the risks involved; and
- applying judgement in cash flows specific to CGUs.

Changing the assumptions selected by management, in particular the discount rate and the growth rate used in the cash flow projections, could significantly affect the impairment evaluations and recoverable amounts.

The Company's impairment tests include key assumptions related to the scenarios discussed above. Further details are provided in note 17 to the financial statements.

***(ii) Deferred income taxes***

The timing of reversal of temporary differences and the expected income allocation to various tax jurisdictions within Canada affect the effective income tax rate used to compute the deferred income taxes. Management estimates the reversals based on historical and budgeted operating results and income tax laws existing at the reporting dates. In addition, management occasionally estimates the current or future deductibility of certain expenditures, affecting current or deferred income tax balances and expenses.

***(iii) Estimated useful lives***

The useful lives of property and equipment are based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for depreciation of property and equipment for any period are affected by these estimated useful lives. It is possible that changes in these factors may cause significant changes in the amount of depreciation recorded in respect of the Company's property and equipment in the future.

***(iv) Café lease provisions***

Café lease provisions are based on the evaluation of the likelihood and measurement of settlements, temporary payouts, or sub-leasing. Management works with landlords, franchisees and uses previous experience to obtain adequate information needed to make these assessments.

***(v) Allowance for doubtful accounts***

The allowance for impairment of trade and other receivables is established when there is objective evidence that the Company will not be able to collect all amounts due according to the original terms of the receivable. The carrying amount of the asset is reduced through the use of an allowance account, and the amount of the loss is recognized in expenses in the statement of operations and comprehensive loss. When an account is deemed uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are recognized as a recovery in expenses in the statement of operations and comprehensive loss.

**d. Financial instruments**

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets are derecognized when the rights to receive cash flows from the assets have expired or have been transferred and the Company has transferred substantially all risks and rewards of ownership. Financial liabilities are derecognized when obligations are discharged, cancelled or they expire.

Financial assets and liabilities are offset and the net amount reported in the Statements of Financial Position when there is a legally enforceable right to offset the recognized amounts and there is an intention to settle on a net basis or realize the asset and settle the liability simultaneously. Hedge accounting is not used.

On recognition, the Company classifies its financial instruments in the following categories depending on the purpose for which the instruments were acquired:

Financial instrument	Categorization	Recognition method
<b>Financial assets</b>		
Cash and cash equivalents	Loans and receivables	Amortized cost
Restricted cash	Loans and receivables	Amortized cost
Trade and other receivables	Loans and receivables	Amortized cost
Notes and leases receivable	Loans and receivables	Amortized cost
<b>Financial liabilities</b>		
Interest rate swap	Fair value through profit and loss	Fair value
Accounts payable and accrued liabilities	Other financial liabilities	Amortized cost
Gift card liability	Other financial liabilities	Amortized cost
Deposits from franchisees	Other financial liabilities	Amortized cost
Term credit facility	Other financial liabilities	Amortized cost

**(i) Cash and cash equivalents, restricted cash, trade and other receivables, and notes and leases receivable:** Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. Loans and receivables are initially recognized at the amount expected to be received, and if necessary, less a present value discount if collection is to be expected beyond one year. Subsequently, loans and receivables are measured at amortized cost using the effective interest method less a provision for impairment, if necessary.

**(ii) Derivative financial instruments:** derivatives are used in the form of interest rate swaps to manage risks related to its variable rate long-term debt. Unrealized fair value gains and losses pertaining to the interest rate swap are included in interest income (expense).

**(iii) Transaction costs:** Long-term debt is accounted for at fair value, net of any transaction costs incurred and, subsequently, at amortized cost using the effective interest method. Transaction costs associated with instruments recognized at amortized cost are amortized over the expected life of the instrument. This classification has been selected as it results in better matching of the transaction costs with the periods benefiting from the transaction costs.

#### e. Cash and cash equivalents and restricted cash

Cash and cash equivalents include cash on hand, deposits held with banks and other short-term highly liquid investments with original maturities of three months or less. Restricted cash represents cash on deposit with banks that are held in trust of the Co-op Fund and Development Fund as well as \$240 held as security for cash management services.

#### f. Leases receivable

The Company has entered into lease agreements acting as the lessor with certain franchisees relating to point of sale systems ("POS"). The lease term is for the major part of the economic life of the POS although the title is not transferred. Leases are recognized as finance type leases and recorded as leases receivable at an amount equal to the net investment in the lease. Leases receivable are initially recognized at the amount expected to be received, less a present value discount if collection is to be expected beyond one year. Subsequently, leases receivable are measured at amortized cost using the effective interest method less a provision for impairment.

**g. Inventories**

Inventories are stated at the lower of cost and net realizable value, with cost being determined on an average cost basis. Net realizable value is the estimated recoverable amount less applicable selling expenses. If carrying value exceeds net realizable amount, a write-down is recognized. The write-downs are reversed if the circumstances that caused the initial write-down no longer exist.

**h. Property and equipment**

Property and equipment are stated at cost less accumulated depreciation net of any impairment losses. Cost includes expenditures that are directly attributable to the acquisition of the asset. Subsequent costs are included in the asset's carrying value or recognized as a separate asset, as appropriate, only when it is probable that future economic benefits associated with the item will flow to the Company and the cost can be measured reliably. The carrying value of a replaced asset is removed when replaced. Repairs and maintenance costs are charged to the Statements of Operations and Comprehensive Loss during the period in which they are incurred. Where property and equipment construction projects are of a sufficient size and duration, an amount is capitalized for the costs used to finance construction.

Depreciation is calculated using the straight-line basis as this approach best reflects consumption and benefit patterns pertaining to the asset's use. Depreciation is charged commencing when the asset is available for use. The following rates are based on the expected useful lives of the assets:

Leasehold improvements	lesser of 10 years and the remaining term of the lease
Equipment, furniture, fixtures and other	3 to 7 years
Computer hardware	3 years

**i. Intangible assets**

Intangible assets consist of trademarks and software, which are amortized or assessed for impairment as follows:

**(i) Trademarks**

Trademarks consist of trade names, operating procedures and systems and other intellectual property used in connection with the operation of the Second Cup cafés in Canada and are recorded at the historical cost less impairment write-downs. The trademark is an indefinite life intangible asset that is tested annually for impairment or at any time an indicator for impairment exists. The trademark assets do not have continual renewal requirements nor is there any deterioration incurred due to usage. As a result of the combination of the aforementioned, the trademark assets are considered to have indefinite lives.

**(ii) Software**

Purchased software costs are recorded at cost and are amortized commencing when the asset is available for use. Amortization is calculated using the straight-line basis as management believes this approach best reflects consumption and benefit patterns pertaining to the asset's use. The following rate is based on the expected useful life of the asset:

Software	3 to 7 years
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Where software implementation projects are of a sufficient size and duration, an amount is capitalized for the costs used to finance development.

#### **j. Provisions**

Provisions are recognized when there is a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation; and the amount can be reliably estimated. Provisions are measured at the best estimate of the expenditure required to settle the obligation at the end of the reporting period and are discounted to present value where the effect is material. Evaluations are performed to identify onerous contracts and, where applicable, provisions are recorded for such contracts.

Provisions for café closures are estimates for costs expected to be incurred by the Company for operational franchisee-owned cafés. Lease and other occupancy costs not expected to be fully paid by the franchisee are recorded as the Company has liability on the café head lease.

#### **k. Other liabilities**

##### **(i) Deferred revenue**

The Company has entered into several supply agreement contracts and receives allowances from certain suppliers in consideration for the café network achieving certain volume thresholds over the term of the supply agreement. Deferred revenue is amortized over the term of the supply agreements based on the proportion of volume thresholds met during the fiscal year or other rational basis.

Cash received from franchisees for the commencement of a new franchise term or a pending transfer arrangement are deferred as deposits from franchisees until the revenue recognition criteria are met.

##### **(ii) Leasehold inducements**

Leasehold inducements are amortized to rent expense on a straight-line basis over the term of the lease.

#### **l. Income taxes**

Income taxes comprise current and deferred income taxes. Income taxes are recognized in the Statements of Operations and Comprehensive Loss except to the extent that they relate to items recognized directly in equity, in which case the income tax is also recognized directly in equity. Current income taxes are the expected taxes payable on the taxable income for the period, using tax rates enacted, or substantively enacted, at the end of the reporting period, and any adjustment to tax payable in respect of previous periods.

Deferred income taxes are recognized in respect of temporary differences arising between the tax bases of assets and liabilities and their carrying values in the financial statements. Deferred income taxes are determined on a non-discounted basis using tax rates and laws that have been enacted or substantively enacted at the Statements of Financial Position dates, and are expected to apply when the deferred income tax asset or liability is settled. Deferred income tax assets are recognized to the extent that it is probable that future taxable profit will be available against which the deductible temporary differences can be utilized.

#### **m. Gift card liability**

The gift card program allows customers to prepay for future purchases by loading a dollar value onto their gift cards through cash or credit/debit cards in the cafés or online through credit cards, when and as needed. The gift card liability represents liabilities related to unused balances on the card net of estimated breakage. These balances are included as sales from franchised cafés, or as revenue of Company-operated cafés, at the time the customer redeems the amount in a café for products. Gift cards do not have an expiration date and outstanding unused balances are not depleted.

When it is determined the likelihood of the remaining balance of a gift card being redeemed by the customer is remote, the amount is recorded as breakage. The determination of the gift card breakage rate is based upon Company-specific historical load and redemption patterns. The 2016 analysis determined that a breakage rate of 3% was applicable to gift card sales, which is consistent with 2015 experience. Gift card breakage is recognized on a pro rata basis based on historical gift card redemption patterns. Breakage income is fully allocated to the Co-op Fund and not recorded in earnings.

#### **n. Deposits from franchisees**

The development process of a new or to be renovated café requires a deposit from a franchisee at the outset. Deposits from franchisees are applied against the cost of constructing a new café or the renovation of an existing café.

#### **o. Revenue recognition**

Revenue is recognized when it is probable that economic benefits will flow to the Company and delivery has occurred, the sales price is fixed or determinable, and collectability is reasonably assured. Revenue is measured at the fair value of the consideration received or receivable. Revenue is reduced for estimated customer returns, rebates and other revenue related concessions.

##### **(i) Royalties**

Royalty revenue from franchised cafés is based on agreed percentage royalty rates of the franchise location sales. Revenue is recognized on an accrual basis in accordance with the substance of the relevant agreement, provided that it is probable that the economic benefits will flow to the Company and the amount of revenue can be measured reliably.

##### **(ii) Services and other**

Services and other consists of initial franchise fees, renewal fees, transfer fees earned on the sale of cafes from one franchisee to another, construction administration fees, purchasing coordination fees, and other ancillary fees (such as IT support and training fees).

##### **(iii) Company-owned cafés and product sales**

Company-owned cafés and product sales revenue includes the sale of goods from Company owned cafés, as well as products sold in grocery stores through wholesale distribution channels and third party licensing agreements.

#### **p. Operating costs and expenses**

##### **(i) Company-owned cafés and cost of product sales**

Company-owned cafés and cost of product sales represents the product cost of goods sold in Company-operated cafés and through the wholesale grocery channel, plus the cost of direct labour to prepare and deliver the goods to the customers in the Company-operated cafés and any occupancy related costs.

##### **(ii) Franchise**

Franchise costs represent the cost of direct labour to support the network, travel and franchisee meetings, business development initiatives as well as professional fees directly related to franchise operations.

##### **(iii) General and administrative**

General and administrative costs include labour and related expenses for head office, professional fees not directly attributable to franchise operations and occupancy costs.

#### q. Operating leases

Operating lease payments are recognized as an expense on a straight-line basis over the lease term. Leasehold inducements are amortized to rent expense on a straight-line basis over the lease term. For the purposes of determining the lease term, option periods are considered for which failure to renew the lease imposes an economic penalty on the Company of such an amount that the renewal appears to be reasonably assured at the inception of the lease.

#### r. Directors' deferred share unit plan

Units granted under the Directors' deferred share unit plan have graded vesting for each month of service completed over the course of one year. Units are paid out in cash upon the termination of the director. Units are granted based on a weighted average price of the Company's shares on the five most recent days preceding the grant date. The fair value of the grants is amortized over the respective vesting period using the graded amortization method. Compensation expense is adjusted for changes in fair value of the Company's share price thereafter. Any dividends paid during the vesting period will be accrued based on the total number of units granted. Amounts recognized are recorded in general and administrative expenses.

Recorded values of the plan are presented as accounts payable and accrued liabilities in the Statements of Financial Position.

#### s. Impairment of financial assets

At each reporting date, the Company assesses whether there is objective evidence that a financial asset is impaired.

The criteria used to determine if there is objective evidence of an impairment loss include:

- significant financial difficulty of the borrower/lessee;
- delinquencies in interest or principal payments; and
- it becomes probable that the borrower/lessee will enter bankruptcy or other financial reorganization.

If such evidence exists, an impairment loss is recognized for assets carried at amortized cost as follows:

The loss is the difference between the amortized cost of the loan or receivable and the present value of the estimated future cash flows, discounted using the instrument's effective interest rate. The carrying value of the asset is reduced by this amount either directly or indirectly through the use of an allowance account.

Notes receivable and leases receivable are assessed for impairment on an individual basis based on the ability of the debtor/lessee to make the required payments and the value of the security. When there is no longer reasonable assurance that a note receivable or lease receivable will be collected, its carrying value is reduced and a charge is recorded in operating expenses.

Impairment losses on financial assets carried at amortized cost are reversed in subsequent years if the amount of the loss decreases and the decrease can be related objectively to an event's occurring after the impairment was recognized.

#### t. Impairment of non-financial assets

Property and equipment and intangible assets without indefinite lives are tested for impairment when events or changes in circumstances indicate the carrying value may not be recoverable. Assets with indefinite lives are subject to an annual impairment test or any time an impairment indicator exists. The yearend date has been selected as the mandatory annual test date.

For the purpose of measuring recoverable amounts, assets are grouped at the lowest levels for which there are separately identifiable cash inflows that are largely independent of the cash inflows from their assets or group of assets, which represent a cash generating unit (CGU). The recoverable amount of each particular CGU is the higher of an asset's fair value less costs of disposal and value in use. CGUs have been determined to be as follows:

- franchising, distribution, and wholesale; and
- Company-operated cafés; each Company-operated café is considered a separate CGU.

The impairment analysis involves comparing the carrying value of the CGUs with their estimated recoverable amounts. An impairment loss is recognized for the amount by which the CGU's carrying value exceeds its recoverable amount. Impairment losses for a CGU reduce first the carrying value of any goodwill allocated to that CGU. Any remaining impairment loss is charged pro rata to the other assets in the CGU.

Impairment losses, other than goodwill impairment, are evaluated for potential reversals when events or circumstances warrant such consideration.

#### u. Related parties

For the purposes of these financial statements, a party is considered related to the Company if such party or the Company has the ability to, directly or indirectly, control or exercise significant influence over the other entity's financial and operating decisions, or if the Company and such party are subject to common influence. Related parties may be individuals or other entities and include members of key management of the Company. All transactions with related parties are recorded at fair value.

#### v. Share-based compensation

For share option awards granted as part of the stock option plan, a fair value is determined at the date of grant and that fair value is recognized in the financial statements over the vesting period. Proceeds arising from the exercise of share option awards are credited to share capital, as are the recognized grant-date fair values of the exercised share option awards. Share option awards which are determined to be settled on a net-equity basis are accounted for as equity instruments. Share option awards which are determined to be settled on a net-cash settlement basis are accounted as liability instruments. The stock option plan was introduced in May 2014 and is further discussed in note 25.

#### w. Reclassification

Certain comparable figures have been reclassified to conform to the current period's financial statement presentation. The change in the restricted cash balance in the previous year cash flow has been reclassified from investing activities to operating activities. This reclassification has been made to enhance the presentation of the company's activities and the financial statements.

#### x. Changes in accounting policies

##### **Recent accounting pronouncements not yet effective**

##### *IFRS 15, Revenue from contracts with customers ("IFRS 15")*

In May 2014, the IASB issued IFRS 15. The core principle of the new standard is for companies to recognize revenue to depict the transfer of goods or services to customers in amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services. IFRS 15 will also result in enhanced disclosures about revenue, provide guidance for transactions that were not previously addressed comprehensively and improve guidance for multiple-element arrangements. The standard will also address accounting for loyalty programs and breakage.

Application of IFRS 15 is effective for annual reporting periods beginning on or after January 1, 2018 and is to be applied using the retrospective or the modified transition approach.

#### *IFRS 16, Leases ("IFRS 16")*

IFRS 16, Leases ("IFRS 16"), sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, the customer ('lessee') and the supplier ('lessor'). This will replace IAS 17, Leases ("IAS 17"), and related Interpretations. IFRS 16 provides revised guidance on identifying a lease and for separating lease and non-lease components of a contract. IFRS 16 introduces a single accounting model for all lessees and requires a lessee to recognize right-of-use assets and lease liabilities for leases with terms of more than 12 months, unless the underlying asset is of low value, and depreciation of lease assets separately from interest on lease liabilities in the income statement.

Under IFRS 16, lessor accounting for operating and finance leases will remain substantially unchanged. IFRS 16 is effective for annual periods beginning on or after January 1, 2019, with earlier application permitted for entities that apply IFRS 15, Revenue from Contracts with Customers. As the Company has contractual obligations in the form of operating leases under IAS 17, there may be a material increase to both assets and liabilities upon adoption of IFRS 16, and material changes to the timing of recognition of expenses associated with the lease arrangements.

The Company expects to report more detailed information including estimated quantitative effect in the Company's 2017 financial statements and is not in a position to make a reliable estimate of the impact, if any, due to the new standard in the financial statements.

### **3. SHARE CAPITAL**

The Company is authorized to issue an unlimited number of common shares. Common shares are classified as equity and have no par value. Incremental costs directly attributable to the issue of new common shares are shown in equity as a deduction, net of tax, from the proceeds.

Shares outstanding at the fiscal year ended December 31, 2016 are 12,830,945 (2015 – 12,830,945).

### **4. MANAGEMENT OF CAPITAL**

On December 2, 2016, the Company entered into a new credit facility which replaced its facility with the Bank of Nova Scotia ("BNS"). As part of the agreement, the Company issued 600,000 warrants that granted the lender the right to purchase, in respect of each warrant, one Common Share in the capital of the Company, at a purchase price of \$2.75 per Common Share, at any time up to December 2, 2020. The revised capital structure of the Company now consists of an \$8,000 (2015 – \$6,000) non-revolving long-term loan and \$23,276 (2015 – \$23,927) in Shareholders' equity, which comprises share capital, warrants, contributed surplus, and retained earnings (deficit).

The Company's objectives relating to the management of its capital structure are to:

- safeguard its ability to continue as a going concern;
- maintain financial flexibility in order to preserve its ability to meet financial obligations;
- maintain a capital structure that provides financing options to the Company when the need arises to access capital; and
- deploy capital to provide an adequate return to its shareholders.

The Company's primary uses of capital are to finance increases in non-cash working capital and capital expenditures.

## 5. FINANCIAL INSTRUMENTS AND FINANCIAL RISK MANAGEMENT

### *Financial instruments*

The following summarizes the nature of certain risks applicable to the Company's financial instruments:

Financial instrument	Risks
<b><i>Financial assets</i></b>	
Cash and cash equivalents	Credit and interest rate
Restricted cash	Credit and interest rate
Trade and other receivables	Credit
Notes and leases receivable	Credit
<b><i>Financial liabilities</i></b>	
Interest rate swap	Credit, liquidity, and interest rate
Accounts payable and accrued liabilities	Liquidity, currency, and commodity
Gift card liability	Liquidity
Deposits from franchisees	Liquidity
Term credit facility	Liquidity and interest rate

### *Fair value of financial instruments*

The fair values of cash and cash equivalents, restricted cash, trade and other receivables, accounts payable and accrued liabilities, provisions, other liabilities and gift card liability approximate their carrying values due to their short-term maturity. The fair value of notes and leases receivable approximates their carrying value as the implicit interest used to discount the base value is considered to be based on an appropriate credit and risk rate pertaining to the debtor. The fair value of the term loan approximates its carrying value less transaction costs due to the floating interest rate of the term loan. The following table summarizes the financial instruments measured at fair value:

	2016	2015
<b>Interest rate swap</b>		
Opening fair value	(\$77)	(\$143)
Repaid during the year	–	70
Change in fair value	77	(4)
Closing fair value	\$–	(\$77)

Financial instruments that are measured subsequent to initial recognition at fair value are to be categorized in Levels 1 to 3 of the fair value hierarchy, based on the degree to which the fair value is observable. The three levels of the fair value hierarchy are:

- Level 1 – inputs derived from quoted prices (unadjusted) in active markets for identical assets or liabilities;
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices); and
- Level 3 – fair value derived from valuation techniques that include inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The fair value for the interest rate swap, classified as Level 2, was derived using market valuation reports provided by a tier one Canadian bank and had a fair value loss of \$77 at December 26, 2015.

There were no changes between levels in the period ended December 31, 2016 versus the period ended December 26, 2015.

#### **Credit risk**

##### **a. Cash and cash equivalents, restricted cash and interest rate swap**

Credit risk associated with cash and cash equivalents, restricted cash and the interest rate swap is managed by ensuring these assets are placed with institutions of high creditworthiness.

##### **b. Trade and other receivables, notes and leases receivable**

Trade and other receivables and notes and lease receivable primarily comprise amounts due from franchisees. Credit risk associated with these receivables is mitigated as a result of the review and evaluation of franchisee account balances beyond a particular age. Prior to accepting a franchisee, the Company undertakes a detailed screening process which includes the requirement that a franchisee has sufficient financing. The risk is further mitigated due to a broad franchisee base that is spread across the country, which limits the concentration of credit risk.

Other receivables may include amounts owing from large organizations where often those organizations have a simultaneous vendor relationship with the Company's franchisees. Credit risk is mitigated as a result of the Company directing and maintaining certain controls over the vendor relationship with the franchisees.

Specific bad debt provisions are accounted for when the expected recovery is less than the actual receivable.

An analysis of aging of trade and other receivables from the billing date net of an allowance for doubtful accounts is as follows:

	0-30 Days	31-60 Days	61-90 Days	> 90 Days	Total
Gross amount as at December 31, 2016	\$2,630	\$173	\$247	\$2,163	\$5,213
Allowance for doubtful accounts	(38)	(67)	(112)	(1,973)	(2,190)
Net amount 2016	\$2,592	\$106	\$135	\$190	\$3,023
Gross amount as at December 26, 2015	\$3,056	\$169	\$134	\$1,809	\$5,168
Allowance for doubtful accounts	(74)	(77)	(85)	(1,498)	(1,734)
Net amount 2015	\$2,982	\$92	\$49	\$311	\$3,434

Trade and other receivables include a combined allowance for doubtful accounts of \$2,190 (December 26, 2015 – \$1,734). Credit terms vary by customer in the range of 30 to 90 days. The net amount due of \$190 aged over 90 days has no specific terms of repayment. Trade and other receivables are further discussed in note 6.

The payment maturity dates of the notes and leases receivable as at December 31, 2016, net of an allowance for doubtful accounts, are as follows:

	< 90 Days	90 Days to < 1 year	1 year to < 2 years	2 years and after	Total
2016	\$32	\$107	\$105	\$68	\$312
2015	\$32	\$88	\$103	\$165	\$388

Notes and leases receivable included a combined allowance for doubtful accounts of \$12 (December 26, 2015 – \$12). Notes and leases receivable are further discussed in note 7.

**Liquidity risk**

Liquidity risk is managed through regular monitoring of forecast and actual cash flows, monitoring maturity dates of financial assets and liabilities, and also the management of the Company's capital structure and debt leverage ratios as outlined in note 14. The Company's main source of income is royalty receipts from its franchisees, corporate café sales, and sales from goods and services.

**Commodity and currency risk**

The Company purchases certain products, such as coffee, in U.S. dollars, thereby exposing the company to risks associated with fluctuations in currency exchange rates. The Company is also directly and indirectly exposed to commodity market risk. The exposure relates to the changes in coffee commodity prices given it is a material input for product offerings. The direct exposure pertaining to the wholesale business is mitigated given that the Company has the ability to adjust its sales price if commodity prices rise over a threshold level. The indirect risk exists where franchisee profitability may be impacted, thus potentially resulting in an impeded ability to collect accounts receivable or the need for other concessions to be made to the franchisee. This risk is mitigated by entering fixed price purchase commitments through coffee commodity brokers and by having the ability to adjust retail selling prices.

**6. TRADE AND OTHER RECEIVABLES**

	2016	2015
Trade and other receivables	\$5,213	\$5,168
Less: Allowance for doubtful accounts	(2,190)	(1,734)
Trade and other receivables – net	<b>\$3,023</b>	<b>\$3,434</b>

During the period, \$576 (2015 – \$352 expense) was recorded as a charge pertaining to trade and other receivables.

**7. NOTES AND LEASES RECEIVABLE**

	2016	2015
Notes receivable – current	\$71	\$67
Lease receivable – current	70	65
Less: Allowance for doubtful accounts – current	(2)	(12)
Notes and leases receivable – current	<b>139</b>	<b>120</b>
Notes receivable – long-term	32	33
Lease receivable – long-term	151	235
Less: Allowance for doubtful accounts – long-term	(10)	–
Notes and leases receivable – long-term	<b>173</b>	<b>268</b>
Notes and leases receivable	<b>\$312</b>	<b>\$388</b>

Notes and leases receivable are discounted using an effective discount rate ranging between eight and nine percent.

## 8. INVENTORIES

Inventories relate to goods held for resale at the corporate cafés and are comprised of the following:

	2016	2015
Merchandise held for resale	\$161	\$181
Supplies	39	48
	<b>\$200</b>	<b>\$229</b>

## 9. PROPERTY AND EQUIPMENT

	Leasehold improvements	Equipment, furniture, fixtures and construction in process	Computer hardware	Total
<b>Net carrying value</b>				
As at December 27, 2014				
Cost	\$2,440	\$4,662	\$709	\$7,811
Accumulated depreciation	(1,106)	(1,914)	(411)	(3,431)
As at December 27, 2014	1,334	2,748	298	4,380
Additions from operations	183	1,628	131	1,942
Additions from franchise stores reacquired	–	–	–	–
Disposals – original cost	(227)	(446)	(5)	(678)
Disposals – accumulated depreciation	118	106	2	226
Capitalized to lease	–	(18)	–	(18)
Depreciation	(309)	(659)	(123)	(1,091)
As at December 26, 2015				
Net carrying value	\$1,099	\$3,359	\$303	\$4,761
<b>Net carrying value</b>				
As at December 26, 2015				
Cost	\$2,396	\$5,826	\$835	\$9,057
Accumulated depreciation	(1,297)	(2,467)	(532)	(4,296)
As at December 26, 2015	1,099	3,359	303	4,761
Additions from operations	76	236	50	362
Additions from franchise stores reacquired	–	20	–	20
Reclass of transfers from construction in process	635	(635)	–	–
Disposals – original cost	(585)	(769)	(4)	(1,358)
Disposals – accumulated depreciation	469	344	3	816
Depreciation	(336)	(689)	(142)	(1,167)
As at December 31, 2016	<b>1,358</b>	<b>1,866</b>	<b>210</b>	<b>3,434</b>
Cost	2,522	4,677	881	8,080
Accumulated depreciation	(1,164)	(2,811)	(671)	(4,646)
As at December 31, 2016	<b>\$1,358</b>	<b>\$1,866</b>	<b>\$210</b>	<b>\$3,434</b>

## 10. INTANGIBLE ASSETS

	Trademarks	Software	Total
<b>Net carrying value</b>			
As at December 27, 2014			
Cost	\$31,144	\$1,939	\$33,083
Accumulated amortization	–	(746)	(746)
As at December 27, 2014	31,144	1,193	32,337
Additions (acquired)	–	733	733
Disposals – original cost	–	(53)	(53)
Capitalized to lease	–	(4)	(4)
Amortization	–	(374)	(374)
As at December 26, 2015	\$31,144	\$1,495	\$32,639
Cost	\$31,144	\$2,615	\$33,759
Accumulated amortization	–	(1,120)	(1,120)
As at December 26, 2015	\$31,144	\$1,495	\$32,639
<b>Net carrying value</b>			
As at December 27, 2014			
Cost	\$31,144	\$2,615	\$33,759
Accumulated amortization	–	(1,120)	(1,120)
As at December 26, 2015	31,144	1,495	32,639
Additions (acquired)	–	393	393
Disposals – original cost	–	(29)	(29)
Disposals – accumulated amortization	–	11	11
Amortization	–	(403)	(403)
As at December 31, 2016	\$31,144	\$1,467	\$32,611
Cost	\$31,144	\$2,979	\$34,123
Accumulated amortization	–	(1,512)	(1,512)
As at December 31, 2016	\$31,144	\$1,467	\$32,611

## 11. ACCOUNTS PAYABLE AND ACCRUED LIABILITIES

Accounts payable and accrued liabilities consist of:

	2016	2015
Accounts payable – trade	\$1,825	\$2,695
Accrued liabilities	1,492	2,241
Accrued salaries, wages, benefits, and incentives	127	199
Sales tax payable – government remittances payable	256	225
	\$3,700	\$5,360

## 12. PROVISIONS

	Headlease liabilities	Café leases (a)	Other (b)	Total
As at December 27, 2014	\$72	\$2,559	\$439	\$3,070
Provisions charged during the period	–	1,422	538	1,960
Provisions utilized during the period	(46)	(1,560)	(787)	(2,393)
As at December 26, 2015	\$26	\$2,421	\$190	\$2,637
Current portion	\$26	\$1,439	\$190	\$1,655
Long-term portion	–	982	–	982
As at December 26, 2015	\$26	\$2,421	\$190	\$2,637
Provisions charged during the period	–	794	186	980
Provisions utilized during the period	(26)	(1,113)	(350)	(1,489)
As at December 31, 2016	\$–	\$2,102	\$26	\$2,128
Current portion	\$–	\$1,572	\$26	\$1,598
Long-term portion	–	530	–	530
As at December 31, 2016	\$–	\$2,102	\$26	\$2,128

### a. Café leases

Provisions for café leases are estimates for costs to be incurred by the Company as a result of the following circumstances: a) closure of cafés, and b) franchisee failure to make payment of occupancy costs at an operational café.

Provisions for café closures of \$794 (2015 – \$1,422) were charged in the year and are reflected in the franchise line on the Statements of Operations and Comprehensive Loss.

### b. Other

Provisions for other items of \$186 (2015 – \$538) were charged in the year. The remaining provision will be settled throughout the course of 2017.

**13. OTHER LIABILITIES**

	2016	2015
Deferred revenue – current	\$181	\$418
Leasehold inducements – current	36	39
Interest rate swap	–	77
Other liabilities – current	217	534
Deferred revenue – long term	52	–
Leasehold inducements – long-term	215	314
Other liabilities – long-term	\$267	\$314
Deferred revenue	\$233	\$418
Leasehold inducements	251	353
Interest rate swap	–	77
Other liabilities	\$484	\$848

**14. LONG-TERM DEBT**

	2016	2015
Face value of long-term debt	\$8,000	\$6,000
Unamortized transaction costs	(819)	(23)
	\$7,181	\$5,977

On December 2, 2016, the Company replaced its previous credit facility with a new facility. The new facility has a face value of \$8,000, matures on December 2, 2020 (with no principal payments prior to December 2, 2020) and new financial covenants. Pursuant to the terms of the Company's new term loan, the Company is subject to certain financial and other customary covenants. The Company is required to maintain certain covenants which are defined in the agreement:

- The Company shall not have negative EBITDA for (a) any trailing four fiscal quarter period (calculated quarterly) or (b) any two consecutive fiscal quarters (calculated quarterly); and
- The Company shall at all times maintain trade accounts payables average age no longer than 30% above the trade accounts payables average age as at September 30, 2016, approximately 28 days (calculated quarterly).

The Company was in compliance with these covenants at December 31, 2016.

The facility bears interest at the Base Rate, as defined in the agreement, which is set at 10.0% per annum. The credit facility is comprised of an \$8,000 (2015 – \$6,000) non-revolving term loan. The loan is collateralized by substantially all the assets of the Company and matures on December 2, 2020.

In conjunction with the new credit facility, the Company granted the lender 600,000 warrants to purchase the equivalent number of common shares at a price of \$2.75. These warrants expire on December 2, 2020 and have been assigned a fair value of \$0.62 using the Black-Scholes model and have been included in the unamortized transaction costs. Key assumptions in the calculation of fair value include volatility of 41%, interest rate of 1.06% and dividend rate of nil. The warrants have been recorded at fair value net of deferred income tax of \$99 to account for the temporary difference between accounting and tax treatment for the warrants.

## 15. REVENUE

	2016	2015
<b>Franchise revenue</b>		
Royalties	\$10,509	\$10,553
Services and other	5,179	4,706
	15,688	15,259
<b>Company-owned cafés and product sales</b>	14,663	22,082
	\$30,351	\$37,341

## 16. OPERATING EXPENSES

	2016	2015
<b>Company-owned cafés and cost of product sales</b>		
Cost of product sales	\$5,795	\$8,560
Labour and related expenses	4,873	6,869
Occupancy and other	5,013	6,953
Depreciation of property and equipment	394	474
Loss (gain) on disposal of assets	225	(21)
	16,300	22,835
<b>Franchise</b>		
Labour and related expenses	4,330	4,069
Travel and franchisee meetings	670	868
Business development initiatives	–	653
Professional fees and other	3,103	3,219
	8,103	8,809
<b>General and administrative</b>		
Labour and related expenses	2,003	1,954
Professional fees and other	3,322	3,400
Occupancy	454	433
Depreciation and amortization	1,154	991
	6,933	6,778
	\$31,336	\$38,422

## 17. IMPAIRMENT OF ASSETS

### a. Impairment of Trademarks

The Company's trademarks are allocated fully to the franchising, distribution, and wholesale CGU. The CGU's recoverable amount has been determined using fair value less costs of disposal.

### Key assumptions

The Company uses a discounted cash flow methodology, which includes the use of estimates and assumptions that are sensitive to change and require judgement. This methodology used to test impairment is classified as Level 3 per the hierarchy described in note 5. These key judgements include estimates of discount rates, forecast growth in system sales and other estimates impacting future cash flows. Changes in these estimates and assumptions may have a significant impact on recoverable amounts. General market uncertainty and the competitive operating environment for the Company and other similar retail entities were also factors taken into account in the analysis. The changes in the market growth rates reflect the current general economic pressures now impacting the national economy.

Probability weighted cash flow projections are used based on financial forecasts covering a three-year period. These projections are approved by the Board of Directors based on management's expectations of potential outcomes. Cash flows beyond the three-year period are extrapolated using the estimated growth rates as stated in the table below. The valuation of the franchising, distribution, and wholesale business CGU is based on various probabilities assigned to each forecasted cash flows. The analysis performed as at December 31, 2016 does not indicate any impairment (2015 – \$nil). The following are key assumptions used in the fair value less costs of disposal calculation as well as a sensitivity analysis for the various range of assumptions used and the related impact.

	2016		2015	
	Low growth	High growth	Low growth	High growth
Discount rate	12.0%	16.0%	12.0%	16.0%
Forecast same café sales avg. growth rate	(1.0%)	2.5% – 4.0%	(1.0%)	6.0 – 9.3%
Avg. growth rate used to extrapolate cash flows beyond the forecast period	0.0%	0.0%	0.0%	3.2%
Amount by which recoverable amount exceeds carrying amount	\$4,500	\$28,400	(\$4,273)	\$23,814

### b. Corporate cafes – Impairment of leasehold improvements, equipment, furniture, fixtures, and other

Impairment indicators include when an individual Company-operated café experiences poor performance directly impacting cash flows. The impairment analysis is based on historical and forecasted performance measures for each café with impairment indicators. The asset's recoverable amount has been determined using value in use. The recoverable amount was compared to the net book value of the assets. This methodology used to test impairment is classified as Level 3 per the hierarchy described in note 5. As a result of the impairment test, impairment charges of \$nil for the year ended December 31, 2016 (2015 – \$nil) were recorded to assets that were not able to be redeployed to a different CGU as the carrying amount exceeded the recoverable amount. A sensitivity of 2% increase or decrease in sales for each CGU pertaining to the impacted assets would not have had an impact on the impairment recorded.

## 18. INTEREST AND FINANCING

	2016	2015
Interest expense	\$259	\$559
Amortization of deferred financing costs	31	21
Interest income	(35)	(123)
	\$255	\$457

## 19. INCOME TAXES

Income taxes, as reported, differ from the amount that would be computed by applying the combined Canadian federal and provincial statutory income tax rate to income before income taxes. The reasons for the differences are as follows:

	2016	2015
Loss before income taxes	(\$1,240)	(\$1,538)
Combined Canadian federal and provincial tax rate	26.68%	26.44%
Tax recovery at statutory rate	(331)	(407)
Increased (reduced) by following differences		
Change in tax rates	22	–
Non-deductible permanent differences	19	19
Other	25	3
Income tax recovery	(\$265)	(\$385)
Current income tax recovery	(\$503)	(\$596)
Deferred income tax expense (recovery)	238	211
Income tax recovery	(\$265)	(\$385)

The blended weighted average statutory income tax rate is an aggregate of the following:

	2016	2015
Basic federal rate	15.00%	15.00%
Weighted average provincial rate	11.68	11.44
Combined Canadian federal and provincial tax rates	26.68%	26.44%

The movement in deferred income tax (assets) and liabilities during the year is as follows:

	Property and equipment	Trademarks	Warrants	Other	Total
As at December 27, 2014	\$1,791	\$2,368	\$–	(\$889)	\$3,270
Charged (credited) to the income statement	153	(4)	–	62	211
As at December 26, 2015	\$1,944	\$2,364	\$–	(\$827)	\$3,481
Charged (credited) to the income statement	67	21	–	150	238
Charged (credited) to equity	–	–	99	–	99
As at December 31, 2016	\$2,011	\$2,385	\$99	(\$677)	\$3,818

**20. BASIC AND DILUTED LOSS PER SHARE**

Loss per share is based on the weighted average number of shares outstanding during the period. Share option awards and warrants to purchase shares are excluded due to anti-dilutive impact. Basic and diluted loss per share is determined as follows:

	2016	2015
Net loss	(\$975)	(\$1,153)
Weighted average number of shares issued and outstanding	12,830,945	12,830,945
Basic and diluted loss per share	(\$0.08)	(\$0.09)

**21. SUPPLEMENTAL CASH FLOW INFORMATION**

	2016	2015
<b>Changes in non-cash working capital &amp; other (inflow (outflow)):</b>		
Trade and other receivables	\$411	\$592
Inventories	29	(8)
Prepaid expenses and other assets	176	58
Accounts payable and accrued liabilities	(1,658)	(651)
Provisions	(483)	(388)
Other liabilities	(282)	(103)
Gift card liability	(70)	(172)
Deposits from franchisees & change in restricted cash	(566)	(517)
Income taxes	155	12
	(\$2,288)	(\$1,177)
<b>Cash payments for capital expenditures</b>		
Cash payments for capital expenditures	(\$382)	(\$1,942)
Cash payments for intangible assets	(393)	(733)
	(\$775)	(\$2,675)
<b>Supplementary information</b>		
Interest paid	318	523
Income taxes paid	\$-	\$-

## 22. RESTRICTED CASH

The Company has established certain accounts that have been classified as restricted cash primarily representing: a) deposits from franchisees for the cost of constructing a new café or the renovation of an existing café, b) funds contributed for use in advertising and promotional programs where the Company is acting as an agent on behalf of the Co-op Fund, and c) a deposit held by the Company's bank as security for cash management services.

	2016	2015
Development Fund	\$1,220	\$521
Co-op Fund	487	319
Security Deposit held by bank	240	–
<b>Total Restricted Cash</b>	<b>\$1,947</b>	<b>\$840</b>

A summary of activities in 2016 and 2015 in the Co-op Fund is provided as follows:

	2016	2015
Co-op Fund – opening balance	\$319	\$61
Amounts contributed by franchisees	2,728	3,438
Amounts contributed by Company for Company-owned cafés	280	376
Amounts paid to third party suppliers for goods and services	(2,486)	(3,556)
Amounts repaid to Company in respect of promissory notes	(354)	–
<b>Co-op Fund – closing balance</b>	<b>\$487</b>	<b>\$319</b>

## 23. CONTINGENCIES, COMMITMENTS AND GUARANTEES

The Company has lease commitments for Company-operated cafés and acts as the head tenant on most leases, which it in turn subleases to franchisees. To the extent the Company may be required to make rent payments due to headlease commitments, a provision has been recognized (note 12). The lease commitments, over the term of the leases, as at December 31, 2016 are as follows:

	Headlease commitments	Sublease to franchisees	Net
December 30, 2017	\$17,792	\$15,793	\$1,999
December 29, 2018	15,960	13,970	1,990
December 28, 2019	13,994	12,089	1,905
December 26, 2020	11,584	9,927	1,657
December 25, 2021	9,822	8,348	1,474
Thereafter	27,423	22,545	4,878
	<b>\$96,575</b>	<b>\$82,672</b>	<b>\$13,903</b>

The Company believes it has sufficient resources to meet the net commitment of \$13,903 over the term of the leases.

The Company is involved in litigation and other claims arising in the normal course of business. Judgement must be used to determine whether or not a claim has any merit, the amount of the claim and whether to record a provision, which is dependent on the potential success of the claim. It is believed that no significant losses or expenses will be incurred with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time, and adjustments, if any, will be recorded in the period of settlement.

Contracts are in place with third party companies to purchase the coffee that is sold in all cafés. In terms of these supply agreements, there is a guaranteed minimum value of coffee purchases of \$849 USD (2015 – \$2,464 USD) for the 12 months. The coffee purchase commitment is comprised of two components: unapplied futures commitment contracts and fixed price physical contracts.

Due to the Company acting as the primary coordinator of café construction costs on behalf of its franchisees and for Company-operated cafés, there is \$241 (2015 – \$265) of contractual commitments pertaining to construction costs for new locations and renovations as at the end of the fiscal year. Construction costs financed for franchise projects are from deposits received from franchisees and for corporate projects from the Company's cash flows.

## 24. RELATED PARTIES

Related parties are identified as key management, members of the Board of Directors and shareholders that effectively exercise significant influence on the Company. Such related parties include any entities acting with or on behalf of the aforementioned parties.

### Compensation of key management

Key management is defined as the senior management team and the Board of Directors. The following summarizes the compensation expense of key management personnel and the composition thereof:

	2016	2015
Salaries and short-term employee benefits	\$2,455	\$2,364
Termination costs	–	142
Share-based compensation	73	36
Total compensation	\$2,528	\$2,542

## 25. SHARE-BASED COMPENSATION

### Stock option plan

The stock option plan was introduced in May 2014 to advance the interests of the Company by:

- providing eligible persons with incentives;
- encouraging share ownership by participants;
- increasing the proprietary interest of participants in the success of the Company;
- encouraging participants to remain with the Company or its affiliates; and
- attracting new directors and employees.

Stock options are to be settled on a net-equity basis. Compensation expense for stock awards is recognized using the fair value when the stock awards are granted using the Black-Scholes option pricing model. All options vest in tranches and are amortized over the awards' vesting period using the accelerated expense attribution method. Recognition of the expense is recorded as a charge to operating expenses with a corresponding increase to contributed surplus.

The following weighted average assumptions have been used to estimate the weighted average fair value per award of \$0.41 granted as of December 31, 2016:

	Assumption
Risk-free interest rate (%)	1.71
Volatility (%)	32.17
Expected term (years)	7.8

The table below summarizes all activity for the year ended December 31, 2016:

	Number of share options outstanding	Weighted average share option price
As at December 26, 2015	715,000	\$4.09
Granted	60,000	3.21
Forfeited	(105,000)	3.65
As at December 31, 2016	670,000	\$4.08
Stock option plan expense during the 53-week period		\$53

The range of exercise prices for share options outstanding at December 31, 2016 is \$3.13 to \$4.54. Of the share options outstanding, 204,000 share options are exercisable. The weighted average years to expiration are approximately eight years. Share award options are able to be exercised upon vesting.

## 26. DIRECTORS' DEFERRED SHARE UNIT PLAN

A summary of the status of the Company's directors' deferred share unit plan is presented below:

	Notional units	Recorded value
Notional units outstanding as at December 27, 2014	39,354	\$120
Deferred units granted	36,049	110
Change in fair value	–	(11)
Notional units outstanding as at December 26, 2015	75,403	\$219
Expensed in the period		\$99
	Notional units	Recorded value
Notional units outstanding as at December 26, 2015	75,403	\$219
Deferred units granted	36,878	110
Change in fair value	–	(90)
Notional units outstanding as at December 31, 2016	112,281	\$239
Expensed in the period		\$20

The fair value price of deferred units granted was \$2.98 (2015 – \$3.05).

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# Shareholder Information

## **CORPORATE HEAD OFFICE**

The Second Cup Ltd.  
6303 Airport Road, 2nd Floor  
Mississauga, Ontario  
Canada L4V 1R8

## **Registrar and Transfer Agent**

Computershare Trust  
Company of Canada

## **Auditors**

PricewaterhouseCoopers LLP

## **Market Information**

Shares Listed:  
Toronto Stock Exchange  
Symbol: SCU

## **Investor Inquiries**

Barbara Mallon  
Vice President, Finance  
and Chief Financial Officer  
Tel: (905) 362-1824  
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E-mail:  
investor@secondcup.com

## **Website**

[www.secondcup.com](http://www.secondcup.com)

## **THE SECOND CUP LTD.**

### **Board of Directors**

Michael Bregman <sup>(1),(2)</sup>  
Chairman

Alix Box

Stephen Kelley <sup>(1)</sup>

Garry Macdonald

Alton McEwen <sup>(2)</sup>

Rael Merson <sup>(1)</sup>

Alan Simpson <sup>(2)</sup>

### **Committees of the Board**

(1) Audit Committee

(2) Governance, Human  
Resources and  
Compensation Committee

## **THE SECOND CUP LTD.**

### **Senior Management Team**

#### **Alix Box**

President and  
Chief Executive Officer

#### **Barbara Mallon**

Vice President, Finance  
and Chief Financial Officer

#### **Vanda Provato**

Vice President,  
Marketing and Category

#### **Chris Sonnen**

Vice President,  
Coffee Experience

#### **Audra Wosik**

Vice President, Franchising

#### **Ted Tai**

Vice President, Operations

#### **John Kazmierowski**

Vice President, Development-  
Leasing & Construction

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COFFEE CO.™**