

**BUSINESS ACQUISITION REPORT**

**1. Identity of the Company**

**1.1 Name and Address of Company**

MTY Food Group Inc. (the "Company")  
8150 route Transcanadienne, suite 200  
St-Laurent, Québec  
H4S 1M5

**1.2 Executive Officer**

The following individual is knowledgeable about the significant acquisition and this business acquisition report:  
Mr. Eric Lefebvre  
Chief Executive Officer  
Telephone: (514) 336-8885

**2. Details of acquisition**

**2.1 Nature of business acquired**

On May 23, 2019, the Company, through the merger of a wholly-owned subsidiary with Papa Murphy's Inc. ("PM"), acquired all the outstanding shares of PM.

PM is the franchisor or operator of approximately 1,400 restaurants operating primarily in the United States with some locations in Canada and Internationally. System sales of the franchise system exceeded \$809 million USD during the most recent completed financial period.

PM generates most of its revenues from collecting royalties from stores based on a percentage of sales as well as from the sale of company-owned stores. It also derives revenues from e-commerce fees as well as from the collection of promotional funds from stores based on a percentage of sales.

**2.2 Date of acquisition**

May 23<sup>rd</sup>, 2019

**2.3 Consideration**

Under the terms of the transaction agreement, the consideration payable for the shares of PM was approximately \$258 million. Financing for the acquisition was sourced from the Company's existing credit facilities.

**2.4 Effect on financial position**

The Company does not have any plans or proposals for material changes to the affairs of PM that may have a significant effect on the financial performance or financial position of PM or of the Company.

**2.5 Prior valuations**

No valuation opinion was obtained in the last 12 months.

**2.6 Parties to transaction**

The transaction was not with an informed person, associate or affiliate of the Company.

**2.7 Date of report**

August 5, 2019

### **3. Financial statements**

#### **3.1 Audited annual financial statements and unaudited interim financial statements**

The following financial statements of Papa Murphy's Inc. are included in and form an integral part of this business acquisition report:

- 3.1.1 The audited USD financial statements of Papa Murphy's Inc. together with the accompanying report of independent registered public accounting firm, as at December 31, 2018 and for the 52 weeks then ended with comparative period in the preceding financial year (Schedule 1).
- 3.1.2 The unaudited USD interim financial statements of Papa Murphy's Inc. as at April 1, 2019 with comparative period in the preceding financial year (Schedule 2).

#### **3.2 Pro forma financial statements**

We include in this business acquisition report the following unaudited condensed combined financial information and related notes of MTY Food Group and Papa Murphy's Inc. (the "Pro Forma Financial Statements"):

- 3.2.1 Unaudited pro forma condensed combined statements of income for the year ended November 30, 2018 and the three months ended February 28, 2019 presented as if the transaction occurred on December 1, 2017 and December 1, 2018 respectively (Schedule 3).

## Forward-looking statements

Certain information in this business acquisition report is forward-looking within the meaning of Canadian Securities laws as it relates to anticipated financial performance, events or strategies. When used in this context, words such as "may", "will", "would", "believe", "plan", "expect", "estimate", "continue", "propose", or the negative of these terms or variations of them, the use of conditional tense or words and expressions of similar nature, are intended to identify forward looking statements and therefore would suggest future outcomes.

The unaudited pro forma condensed consolidated financial statements presented in this report do not necessarily reflect the results that would have existed had the acquisition been completed on the dates indicated and are not necessarily representative of the future financial position and results of the Company following the acquisition.

The unaudited pro forma condensed consolidated statement of income presented in this report do not include integration costs, operating cost savings and other elements that could have occurred if the acquisition had taken place before March 23, 2019.

Forward-looking information is subject to known and unknown risks, uncertainties and other factors that may cause the actual results, level of activity, performance or achievements of the Company to be materially different from those expressed or implied by such forward-looking information, including the finalization of the purchase price allocation, the fair value of assets acquired and liabilities assumed, the final settlement of any adjustments under the purchase and sale agreement, completing the analysis of the tax treatment of the acquisition, recording any related future income taxes adjustments, exchange rate variations and the effective corporate tax rate and incurring additional expenses in connection with the transaction, as well as those factors discussed in the section "Risk Factors" of the Company's Management Discussion and Analysis and Annual Information Form for the year ended November 30, 2018, which can be found on [www.sedar.com](http://www.sedar.com).

Forward-looking information is based on the reasonable assumptions, estimates, analysis and opinions of management made in light of its experience and its perception of trends, current conditions and expected developments, as well as other factors that management believes to be relevant and reasonable in the circumstances at the date that such statements are made but may prove to be inaccurate. Although the Company believes the assumptions and expectations reflected in such forward-looking information are reasonable, undue reliance should not be placed on forward-looking information because the Company can give no assurance that such expectations will prove to be correct. Readers are cautioned that the foregoing is not exhaustive of all factors and assumptions that may have been used.

Although the Company has attempted to identify important factors that could cause actual results to differ materially from those contained in forward-looking information, there may be other factors that cause results not to be as anticipated, estimated or intended. There can be no assurance that such information will prove to be accurate as actual results and future events could differ materially from those anticipated in such information. Accordingly, readers should not place undue reliance on forward-looking information. The Company does not undertake to update any forward-looking information, except in accordance with applicable securities laws.

# Schedule 1

Note: the auditors have not given their consent to include their audit report in this report.

# Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of  
Papa Murphy's Holdings, Inc.

## ***Opinion of the Financial Statements***

We have audited the accompanying consolidated balance sheets of Papa Murphy's Holdings, Inc. and subsidiaries (the "Company") as of December 31, 2018 and January 1, 2018, the related consolidated statements of operations, shareholders' equity, and cash flows for the years then ended, and the related notes and schedules (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and January 1, 2018, and the consolidated results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

## ***Change in Accounting Principles***

As discussed in Note 2 to the consolidated financial statements, effective January 2, 2018, the Company changed its method of accounting for revenue recognition due to the adoption of Accounting Standards Codification ("ASC") Topic No. 606, and its method of accounting for leases due to the adoption of ASC Topic No 842.

## ***Basis for Opinion***

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits, we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Moss Adams LLP

Portland, Oregon  
March 14, 2019

We have served as the Company's auditor since 2006.

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Consolidated Statements of Operations

<i>(In thousands, except share and per share data)</i>	Fiscal Year Ended	
	December 31, 2018	January 1, 2018
<b>Revenues</b>		
Franchise .....	\$ 64,653	\$ 71,640
Company-owned store sales .....	61,776	76,868
Total revenues .....	126,429	148,508
<b>Costs and Expenses</b>		
Store operating costs:		
Cost of food and packaging .....	20,415	25,958
Compensation and benefits .....	19,601	23,603
Advertising .....	4,794	6,684
Occupancy and other store operating costs .....	11,441	13,931
Selling, general, and administrative .....	49,731	64,565
Depreciation and amortization .....	7,241	10,452
Loss on disposal or impairment of property and equipment .....	1,937	18,360
Total costs and expenses .....	115,160	163,553
<b>Operating Income (Loss)</b> .....	11,269	(15,045)
Interest expense, net .....	5,212	5,078
Loss on early retirement of debt .....	38	—
Other expense, net .....	212	204
<b>Income (Loss) Before Income Taxes</b> .....	5,807	(20,327)
Provision for (benefit from) income taxes .....	1,483	(18,509)
<b>Net Income (Loss)</b> .....	\$ 4,324	\$ (1,818)
Earnings (loss) per share of common stock		
Basic .....	\$ 0.26	\$ (0.11)
Diluted .....	\$ 0.25	\$ (0.11)
Weighted average common stock outstanding		
Basic .....	16,929,764	16,870,013
Diluted .....	17,000,858	16,870,013

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Consolidated Balance Sheets

(In thousands, except par value and share data)

	December 31, 2018	January 1, 2018
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 5,766	\$ 2,174
Accounts receivable, net	3,564	3,788
Inventories	549	719
Prepaid expenses and other current assets	2,173	2,281
Total current assets	12,052	8,962
Property and equipment, net	4,866	10,064
Operating lease right of use assets	9,801	16,331
Goodwill	101,763	107,751
Trade name and trademarks	87,002	87,002
Definite-life intangibles, net	27,326	31,655
Assets held for sale	3,117	—
Other assets	797	350
Total assets	<u>\$ 246,724</u>	<u>\$ 262,115</u>
<b>LIABILITIES AND EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 4,773	\$ 5,389
Accrued expenses and other current liabilities	12,389	12,382
Current portion of lease liabilities	2,510	3,382
Current portion of unearned franchise and development fees	1,715	1,564
Current portion of long-term debt	11,400	8,400
Total current liabilities	32,787	31,117
Long-term debt, net of current portion	70,644	86,994
Lease liabilities, net of current portion	8,806	16,296
Unearned franchise and development fees, net of current portion	8,546	10,037
Deferred tax liability, net	23,121	21,825
Other long-term liabilities	3,797	1,704
Total liabilities	147,701	167,973
Commitments and contingencies (Note 17)		
<b>Equity</b>		
Preferred stock (\$0.01 par value; 15,000,000 shares authorized; no shares issued or outstanding)	—	—
Common stock (\$0.01 par value; 200,000,000 shares authorized; 17,025,028 and 16,971,461 shares issued and outstanding, respectively)	170	170
Additional paid-in capital	121,171	120,614
Accumulated deficit	(22,318)	(26,642)
Total equity	99,023	94,142
Total liabilities and equity	<u>\$ 246,724</u>	<u>\$ 262,115</u>

See accompanying notes.

## Papa Murphy's Holdings, Inc. and Subsidiaries

### Consolidated Statements of Shareholders' Equity

<i>(In thousands)</i>	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Equity
	Shares	Amount			
<b>BALANCE, January 2, 2017</b> . . . . .	16,956	\$ 170	\$ 119,932	\$ (24,942)	\$ 95,160
Cumulative effect adjustment . . . . .	—	—	—	118	118
Common stock issued . . . . .	35	—	—	—	—
Common stock repurchases . . . . .	(20)	—	(5)	—	(5)
Stock based compensation expense . . . . .	—	—	687	—	687
Net loss . . . . .	—	—	—	(1,818)	(1,818)
<b>BALANCE, January 1, 2018</b> . . . . .	16,971	\$ 170	\$ 120,614	\$ (26,642)	\$ 94,142
Common stock issued . . . . .	64	—	91	—	91
Common stock repurchases . . . . .	(10)	—	(29)	—	(29)
Stock based compensation expense . . . . .	—	—	495	—	495
Net income . . . . .	—	—	—	4,324	4,324
<b>BALANCE, December 31, 2018</b> . . . . .	17,025	\$ 170	\$ 121,171	\$ (22,318)	\$ 99,023

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Consolidated Statements of Cash Flows

(In thousands)	Fiscal Year Ended	
	December 31, 2018	January 1, 2018
<b>Operating Activities</b>		
Net Income (Loss)	\$ 4,324	\$ (1,818)
Adjustments to reconcile to cash from operating activities		
Depreciation and amortization	7,241	10,452
Loss on disposal or impairment of property and equipment	1,937	18,360
Deferred taxes	1,296	(18,689)
Share-based compensation	495	687
Other non-cash items	342	422
Change in operating assets and liabilities		
Accounts receivable	238	1,541
Prepaid expenses and other assets	1,985	4,879
Unearned franchise and development fees	(1,508)	(753)
Accounts payable	(1,208)	(548)
Accrued expenses and other liabilities	(4,902)	1,004
Net cash provided by operating activities	10,240	15,537
<b>Investing Activities</b>		
Acquisition of property and equipment	(576)	(3,987)
Acquisition of stores, less cash acquired	(134)	—
Proceeds from sale of stores	7,599	2,288
Payments received on notes receivable	97	51
Net cash provided by (used in) investing activities	6,986	(1,648)
<b>Financing Activities</b>		
Payments on long-term debt	(13,392)	(12,979)
Advances on revolver	5,900	14,900
Payments on revolver	(5,900)	(15,700)
Repurchases of common stock	(29)	(5)
Proceeds from exercise of stock options	91	—
Debt issuance and modification costs	(304)	—
Net cash used in financing activities	(13,634)	(13,784)
Net change in cash and cash equivalents	3,592	105
<b>Cash and Cash Equivalents, beginning of year</b>	2,174	2,069
<b>Cash and Cash Equivalents, end of period</b>	<b>\$ 5,766</b>	<b>\$ 2,174</b>
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the period for interest	\$ 4,970	\$ 4,835
Cash paid (received) during the period for income taxes	\$ 66	\$ (185)

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

---

## Notes to Consolidated Financial Statements

Note 1	Description of Business	<a href="#">54</a>
Note 2	Summary of Significant Accounting Policies	<a href="#">54</a>
Note 3	Acquisitions	<a href="#">62</a>
Note 4	Prepaid Expenses and Other Current Assets	<a href="#">62</a>
Note 5	Property and Equipment	<a href="#">62</a>
Note 6	Divestitures	<a href="#">63</a>
Note 7	Goodwill	<a href="#">63</a>
Note 8	Intangible Assets	<a href="#">64</a>
Note 9	Financing Arrangements	<a href="#">65</a>
Note 10	Fair Value Measurement	<a href="#">66</a>
Note 11	Accrued and Other Liabilities	<a href="#">67</a>
Note 12	Revenue	<a href="#">67</a>
Note 13	Leases	<a href="#">69</a>
Note 14	Income Taxes	<a href="#">70</a>
Note 15	Share-based Compensation	<a href="#">72</a>
Note 16	Earnings per Share (EPS)	<a href="#">74</a>
Note 17	Commitments and Contingencies	<a href="#">74</a>
Note 18	Retirement Plans	<a href="#">76</a>
Note 19	Brand Marketing Fund	<a href="#">76</a>
Note 20	Segment Information	<a href="#">77</a>
Note 21	Subsequent Events	<a href="#">78</a>

## **Note 1 — Description of Business**

---

Papa Murphy's Holdings, Inc. ("Papa Murphy's" or the "Company"), together with its subsidiaries, is a franchisor and operator of a Take 'N' Bake pizza chain. The Company franchises the right to operate Take 'N' Bake pizza franchises and operates Take 'N' Bake pizza stores owned by the Company. As of December 31, 2018, the Company had 1,437 stores consisting of 1,400 domestic stores (1,294 franchised stores and 106 Company-owned stores) across 37 states, plus 37 franchised stores in Canada and the United Arab Emirates.

Substantially all revenues are derived from retail sales of pizza and other food and beverage products to the general public by Company-owned stores and the collection of franchise royalties and fees associated with franchise and development rights.

## **Note 2 — Summary of Significant Accounting Policies**

---

### **Principles of consolidation and basis of presentation**

These consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States ("GAAP") and include the accounts of Papa Murphy's Holdings, Inc., its subsidiaries, and certain entities which the Company consolidates as variable interest entities ("VIEs"). The Company reports noncontrolling interests in consolidated entities as a component of equity separate from shareholders' equity. All significant intercompany transactions and balances have been eliminated.

The Company participates in various advertising cooperatives with its franchise owners established to collect and administer funds contributed for use in advertising and promotional programs in a specific market designed to increase sales and promote the Papa Murphy's brand. Contributions to the advertising cooperatives are required for both Company-owned and franchised stores and are generally based on a percentage of a store's sales. The Company maintains certain variable interests in these cooperatives. As the cooperatives are required to spend all funds collected on advertising and promotional programs, total equity at risk is not sufficient to permit the cooperatives to finance their activities without additional subordinated financial support. Therefore, these cooperatives are VIEs. As a result of the Company's voting rights exercised through Company-owned stores, the Company consolidates certain of these cooperatives for which it is the primary beneficiary. Advertising cooperative assets, consisting primarily of cash and receivables, can only be used to settle the obligations of the respective cooperative. Advertising cooperative liabilities represent the corresponding obligation arising from the receipt of the contributions to purchase advertising and promotional programs for which creditors do not have recourse to the general credit of a primary beneficiary. Therefore, the Company reports all assets and liabilities of the advertising cooperatives that it consolidates as prepaid expenses and other current assets and accrued expenses and other current liabilities, respectively, in the Consolidated Balance Sheets. Because the contributions to these advertising and marketing cooperatives are specifically designated and segregated for advertising, the Company does not reflect franchise owner contributions to these cooperatives in its Consolidated Statements of Operations or Consolidated Statements of Cash Flows.

### **Fiscal year**

The Company uses a 52- or 53-week fiscal year, ending on the Monday nearest to December 31. Fiscal years 2018 and 2017 were 52-week years. All references to years relate to fiscal periods rather than calendar periods. References to fiscal 2018 and 2017 are references to fiscal years ended December 31, 2018 and January 1, 2018, respectively.

### **Use of estimates**

Preparing financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the Company's consolidated financial statements and accompanying notes. Significant items that are subject to such estimates and assumptions include the estimation of the fair value of acquired assets and liabilities, including fixed assets, goodwill, and intangible assets and the related subsequent impairment analysis, fair value of stock based compensation, asset retirement obligations, lease guarantees, and deferred tax asset valuation allowance. Although management bases its estimates on historical experience and assumptions that are believed to be reasonable in the circumstances, actual results may differ from those estimates.

## Cash and cash equivalents

The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents. The Company maintains cash and cash equivalent balances with financial institutions that periodically exceed federally insured limits. The Company also holds limited funds, to the extent necessary, on deposit outside the United States. The Company makes such deposits with entities it believes are of high credit quality and has not incurred any losses related to these balances. Management believes its credit risk to be minimal.

All credit card, debit card, and electronic benefits transfer transactions that process in less than seven days are classified as cash and cash equivalents. The amounts due from banks for these transactions classified as cash and cash equivalents totaled \$0.4 million and \$1.0 million as of the end of fiscal 2018 and 2017, respectively.

## Accounts receivable

Accounts receivable consist primarily of (a) amounts due from franchise owners for continuing fees that are collected weekly, (b) receivables for vendor rebates and (c) other miscellaneous receivables. Accounts receivable are stated net of an allowance for doubtful accounts determined by management through an evaluation of specific accounts, considering historical losses and existing economic conditions where relevant. Allowance for doubtful accounts amounted to \$70,000 and \$67,000 as of the end of fiscal 2018 and 2017, respectively.

## Notes receivable

Notes receivable consist primarily of amounts due from sales of Company-owned stores. Management reviews the notes receivable on a periodic basis and evaluates the creditworthiness and financial condition of the counterparty to determine the appropriate allowance, if any. If the store owner does not repay the note, the Company has the contractual right to take back ownership of the store based on the underlying franchise agreement, which therefore minimizes the credit risk to the Company.

## Inventories

Inventories consist principally of food products and packaging supplies for use in Company-owned stores. Inventories are valued at the lower of cost, determined under the first-in, first-out method or net realizable value.

## Property and equipment

Property and equipment are recorded at cost. Property and equipment are depreciated using the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized using the straight-line method over the shorter of the useful lives of the assets or the related lease term, including renewal options to the extent renewals are reasonably assured, not to exceed 10 years.

The estimated useful lives for property and equipment are:

<u>Property and Equipment</u>	<u>Estimated Useful Life</u>
Leasehold improvements	Shorter of lease term or estimated useful life, not to exceed 10 years
Restaurant equipment and fixtures	5 to 7 years
Office furniture and equipment	3 to 7 years
Software	3 to 5 years
Vehicles	5 years

## Deferred financing costs

Costs incurred to obtain long-term financing are accounted for as a deferred charge and amortized to interest expense over the terms of the respective debt agreements using the effective interest method. Unamortized deferred charges are recorded as a reduction from the carrying amount of the related debt liability in the Company's Consolidated Balance Sheets.

## Goodwill and other intangible assets

Goodwill arises from business combinations and represents the excess of the purchase consideration transferred over the fair value of the net assets acquired, including identifiable intangible assets and liabilities assumed. The majority of the

Company's goodwill was generated in May 2010 when affiliates of Lee Equity Partners, LLC ("Lee Equity") acquired all of the equity interests of PMI Holdings, Inc. ("Lee Equity Acquisition"), though the Company has also recognized goodwill upon the acquisition of stores from franchise owners. Goodwill is assigned to reporting units for purposes of impairment testing.

The Company considers its trade name and trademarks to be indefinite-lived intangible assets. These assets were initially recognized in May 2010 upon the Lee Equity Acquisition. The Company's intangible assets that are not indefinite-lived include franchise relationships and reacquired franchise rights.

Goodwill and intangible assets determined to have an indefinite life are not amortized, but are tested for impairment annually, or more often if an event occurs or circumstances change that indicate an impairment might exist. Management evaluates indefinite-lived assets each reporting period to determine whether events and circumstances continue to support an indefinite useful life. Intangible assets with finite lives are amortized over their estimated useful lives on a straight-line basis and tested for impairment together with long-lived assets.

In performing its annual goodwill impairment test, the Company first assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is not "more likely than not" that the fair value of a reporting unit is less than its carrying amount. If the Company determines that it is more likely than not, it performs the two-step quantitative goodwill impairment test. Under the two-step quantitative goodwill impairment test, the fair value of the reporting unit is compared to its respective carrying amount, including goodwill. If the fair value exceeds the carrying amount, then no impairment exists. If the carrying amount exceeds the fair value, further analysis is performed to determine the amount of the impairment. Both the qualitative and quantitative assessments are completed separately with respect to the goodwill of each of the Company's reporting units. The Company reviews goodwill for impairment annually, as of the first day of its fourth fiscal quarter, or more frequently if indicators of impairment exist. The Company can bypass the qualitative assessment and move directly to the quantitative assessment for any reporting unit in any period and can elect to resume performing the qualitative assessment in any subsequent period.

Most of the Company's goodwill is attributed to and tested for impairment at the Domestic Franchise segment, which is considered one reporting unit, as the segment does not have any components of a business for which discrete financial information is available and is regularly reviewed by segment management.

In performing its annual impairment test for indefinite-lived intangible assets, the Company first assesses qualitatively whether it is more likely than not that the indefinite-lived intangible asset is impaired, thus necessitating a quantitative impairment test. The Company does not calculate the fair value of an indefinite-lived asset and perform the quantitative test unless it determines that it is more likely than not that the asset is impaired. The Company reviews indefinite-lived intangible assets for impairment annually, as of the first day of its fourth fiscal quarter, or more frequently if indicators of impairment exist. The Company can bypass the qualitative assessment and move directly to the quantitative assessment for any indefinite-lived intangible asset in any period and can elect to resume performing the qualitative assessment in any subsequent period.

### **Impairment of long-lived assets**

Long-lived assets are evaluated for recoverability of the carrying amount whenever events and circumstances indicate the carrying amount of an asset may not be fully recoverable. Some of the events or changes in circumstances that would trigger an impairment review include, but are not limited to, significant under-performance relative to expected and/or historical results (such as two years of comparable store sales decrease or two years of negative operating cash flows), significant negative industry or economic trends, or knowledge of transactions involving the sale of similar property at amounts below the carrying value.

Assets are grouped for recognition and measurement of impairment at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets. Typically, long-lived assets relating to Company-owned stores are tested for impairment at the level of the retail market in which they are located and long-lived assets relating to franchised operations are tested for impairment at each segment level. If the carrying amount of an asset group exceeds the estimated undiscounted future cash flows expected to be generated by the asset, then an impairment charge is recognized to the extent the carrying amount exceeds the asset group's fair value. In determining fair value, management considers current results, trends, future prospects, and other economic factors.

### **Assets held for sale**

Assets are classified as held for sale when management with the appropriate authority commits to a plan to sell the assets, the assets are available for immediate sale, the assets are actively marketed at a reasonable price, the sale is probable within a year, and certain other criteria are met. Assets held for sale consist primarily of Company-owned stores where the Company has committed to a plan to sell specific stores. Assets designated as held for sale are held at the lower of the net

book value or fair value less costs to sell. There is an additional amount of assets held for sale reported in Prepaid expenses and other current assets on the Consolidated Balance Sheets (see *Note 4 — Prepaid Expenses and Other Current Assets*). Depreciation is not charged against property and equipment classified as assets held for sale.

### **Asset retirement obligations (“AROs”)**

AROs are primarily associated with leasehold improvements which, at the end of a lease, the Company is obligated to remove in order to comply with certain lease agreements. At the inception of a lease with such conditions, the Company records an ARO and a corresponding capital asset in an amount equal to the estimated fair value of the obligation. Fair value is estimated based on a number of assumptions requiring management’s judgment, including store closing costs, cost inflation rates, and discount rates in effect at the time the lease is signed. Over time, the obligation is accreted to its projected future value and, upon satisfaction of the ARO conditions, any difference between the recorded liability and the actual retirement costs incurred is recognized as an operating gain or loss in the Consolidated Statements of Operations. The Company had AROs outstanding of \$1.3 million and \$1.6 million as of the end of fiscal 2018 and 2017, respectively, as a component of other liabilities.

### **Revenue recognition**

The Company owns and franchises Papa Murphy’s Take ‘N’ Bake pizza stores. Revenue is recognized upon the transfer of control of promised goods or services to customers in an amount that reflects the consideration the Company expects to receive for those goods or services. The following are the principal activities from which the Company earns revenue:

#### ***Company-owned Stores Revenue***

Company-owned stores revenue consists of retail sales of food through Company-owned stores located in the United States. Company-owned stores revenue is recognized when the food items are delivered to or carried out by customers. Customer payments are generally collected at the time of sale. Sales taxes collected from customers are remitted to the appropriate taxing authority and are not recognized as revenue.

#### ***Franchise Revenues***

The franchise arrangement between the Company and each franchise owner of a Papa Murphy’s Take ‘N’ Bake pizza store is documented in the form of a franchise agreement and, in select cases, a development agreement. The franchise arrangement requires the Company as franchisor to perform various activities to support the Papa Murphy’s Take ‘N’ Bake pizza brand and does not involve the direct transfer of goods and services to the franchise owner as a customer. Activities performed by the Company are highly interrelated with the franchise license and are considered to represent a single performance obligation, which is the transfer of the franchise license. The nature of the Company’s promise in granting the franchise license is to provide the franchise owner with access to the brand’s intellectual property over the term of the franchise arrangement.

The transaction price in a standard franchise arrangement consists of (a) franchise/development fees; (b) continuing franchise fees (royalties); and (c) advertising fees. Since the Company considers the franchise license to be a single performance obligation, no allocation of the transaction price under a standard agreement is performed for revenue recognition purposes. However, if additional separate and distinct goods or services are included with a franchise arrangement and are deemed to be additional performance obligations, the total transaction price of the contract is allocated to each performance obligation based on the stand-alone selling price of each performance obligation.

Franchise revenues are recognized by the Company from the following different sources:

- **Royalty revenues.** Royalty revenues, which include advertising fees from domestic franchise stores, are based on a percentage of sales and are recognized when the food items are delivered to or carried out by customers. Payments for domestic royalties and advertising fees are generally due and collected within seven days of the prior week end date. Payments for international royalties are due and collected within 30 days of month-end.
- **Franchise and development fees.** Franchise and development fees are paid in advance of a store opening, typically when entering into a new franchise or development agreement. Fees allocated to the franchise license are recognized as revenue on a straight-line basis over the term of each respective franchise store agreement. Initial franchise agreement terms are typically ten years while successive agreement terms are typically five years. The Company has determined that these fees, which are paid in advance of when they are recognized as revenue, do not contain a significant financing component.
- **E-commerce fees.** E-commerce fees include point-of-sale (“POS”) support fees and transaction fees for purchases made through the Company’s e-commerce platform. POS support fees are due quarterly in advance and

recognized as revenue over the respective quarter. Transaction fees are recognized when the food items purchased from a store are delivered to or carried out by customers and are due and collected within seven days of the prior week end date.

- **Vendor payments.** Vendor payments are received from vendors that supply franchised and Company-owned stores with products and are typically based on the volume of product purchased by the stores. Revenues from the sale of products are recognized when product is shipped from a distribution center to a store. Payments are due and collected within 30 days after month-end.
- **Marketing kits.** The Company charges domestic stores for marketing materials shipped to stores one to three times per quarter. These products are sold at cost and the revenues from their sale are recognized when the product is shipped by the vendors producing the kits. Payments are due and collected within 30 days of shipment.
- **Gift cards.** The Company operates a system-wide gift card program and recognizes revenue from gift cards when a gift card is redeemed in a Company-owned store. As gift cards are redeemed by a customer, an estimate of the value of gift card balances that will be unredeemed ("gift card breakage") is recognized by the Company as a contribution to the brand marketing fund described under Advertising and marketing costs below. The Company determines the gift card breakage rate based upon Company-specific historical redemption patterns.

The timing of revenue recognition may differ from the timing of payment from customers. The Company records a receivable when revenue is recognized in advance of payment, and a contract liability ("unearned revenue"), when revenue is recognized subsequent to payment. Unearned revenue consists mainly of franchise and development fees paid in advance. A refund liability is recorded when it is known that an amount previously received will be refunded instead of recognized as revenue. The Company does not incur a significant amount of contract acquisition costs in conducting its franchising activities and has not capitalized any such costs.

## Software revenue recognition

Periodically, the Company acquires point-of-sale ("POS") software licenses in a lump sum purchase. The Company recognizes revenues for the resale of software licenses upon delivery to franchise owners to the extent collectability is probable. The Company had \$0.4 million of software licenses as of the end of fiscal 2018 and 2017 as a component of prepaid expenses and other current assets.

## Advertising and marketing costs

Advertising costs, including contributions to local advertising cooperatives which are based on a percentage of sales, are expensed when incurred except for media development costs, which are expensed when the advertisement is first aired. These costs are included in store operating costs or selling, general, and administrative expenses based on the nature of the advertising and marketing costs incurred.

Franchised and Company-owned stores in the United States contribute to a brand marketing fund ("BMF") that the Company manages on behalf of these stores. In addition, certain suppliers contribute to the BMF. The Company is committed under its franchise and other agreements to spend revenues of the BMF on marketing, creative efforts, media support, or related purposes specified in the agreements. Contributions to the BMF are recognized as revenue, while expenditures are included in selling, general, and administrative expenses. Expenditures of the BMF are primarily amounts paid to third-parties, but may also include personnel expenses and allocated costs. At each reporting date, to the extent contributions to the BMF exceed expenditures on a cumulative basis, the excess contributions are recorded in accrued expenses in the Company's Consolidated Balance Sheets. While no profit is recognized on amounts received by the BMF, when expenditures exceed contributions to the BMF on a cumulative basis, income from operations and net income may be affected due to the timing of when revenues are received and expenses are incurred (see *Note 19 — Brand Marketing Fund*).

## Leases

The Company leases the property for its corporate headquarters, Company-owned stores, and certain office equipment. The Company is not a party to leases for franchise locations except for two locations that operate under a sublease and a few leases assigned to franchisees when stores were refranchised wherein it remains secondarily liable (see *Lease guarantees* below). The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease right-of-use ("ROU") assets, current portion of operating lease liabilities, and operating lease liabilities in the Consolidated Balance Sheets. The Company currently has no finance leases.

ROU assets and operating lease liabilities are recognized based on the present value of lease payments over the lease term at commencement date. Because most of the Company's leases do not provide an implicit rate of return, the Company uses its incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. Operating lease ROU assets also exclude lease incentives received. The Company has lease agreements with lease and non-lease components, which are accounted for separately. For certain equipment leases, such as copiers, the Company accounts for the lease and non-lease components as a single lease component.

Lease expense for lease payments is recognized on a straight-line basis over the lease term. Lease terms for Company-owned stores are generally five years with one or more five-year renewal options and generally require the Company to pay a proportionate share of real estate taxes, insurance, common area, and other operating costs in addition to a base or fixed rent. The Company's leases have remaining lease terms of 0.6 to 9.9 years. For purposes of calculating operating lease liabilities, lease terms may be deemed to include options to extend or terminate the lease when it is reasonably certain that the Company will exercise that option. Economic performance of a store is the primary factor used to estimate whether an option to extend a lease term will be exercised or not.

### **Lease guarantees**

On occasion, the Company becomes a guarantor for certain operating leases when it sells a Company-owned store or a store under construction by the Company. The guarantee obligation is initially measured as the fair value of the guarantee, which is recorded as a liability. The Company recognizes its release from risk as a guarantor as the lease obligation is settled over the remaining lease term. In addition, throughout the guarantee period, the Company records a reserve when any loss becomes probable in connection with such lease guarantee. As of the end of fiscal 2018 and 2017, the Company's liability in connection with the unamortized value of these lease guarantees was \$165,000 and \$69,000, respectively, and no additional liability has been recorded in connection with a probable loss from these guarantees.

### **Income taxes**

The Company accounts for income taxes using the asset and liability approach. This requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial statement and the tax basis of assets and liabilities at the applicable tax rates. A valuation allowance is recorded against deferred tax assets if, based on available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

The effect of uncertain tax positions would be recorded in the consolidated financial statements only after determining a more likely than not probability that the uncertain tax positions would withstand an examination by tax authorities based on the technical merits of the position. The tax benefit to be recognized is measured as the largest amount of benefit that is greater than fifty percent likely of being realized upon ultimate settlement. As facts and circumstances change, management reassesses these probabilities and would record any changes in the financial statements as appropriate.

As of the end of each of fiscal years 2018 and 2017, the Company has recorded reserves for uncertain tax positions totaling \$77,000.

### **Share-based compensation**

The Company awards equity compensation under the Company's 2010 Amended Management Incentive Plan ("2010 Plan") and 2014 Management Incentive Plan ("2014 Plan"), consisting of stock option and restricted stock awards. Restricted stock and stock option awards typically vest based on the achievement of a time-vesting or a market condition. Compensation expense relating to restricted stock with time-vesting conditions is recognized for the portion of the grant date fair value that exceeds any purchase price paid for the stock. This expense is recognized over the requisite service period, typically the vesting period, utilizing the straight-line attribution method.

The fair value of time-vesting stock option awards is estimated on the grant date using a Black-Scholes-Merton option-pricing model. Compensation expense relating to stock option awards is recognized for the grant date fair value. The fair value of stock options that contain a market condition is estimated on the grant date using a Monte Carlo valuation method, which utilizes multiple input variables to determine the probability of the Company achieving the market condition and the fair value of the award. The risk-free interest rate is based on the estimated effective life and is estimated based on U.S. Treasury Yield Curve rates. Since the Company has limited relevant option exercise experience, the expected term is based on a simplified method calculation and the expected volatility is based on the historical volatility of the share price of a group of peer companies. Compensation expense relating to stock option awards is recognized for the grant date fair value. This expense is recognized over the requisite service period, typically the vesting period, utilizing the straight-line attribution method.

## Business Combinations

The Company accounts for business combinations under the acquisition method of accounting, recording any assets acquired and liabilities assumed based upon their respective fair values. Any excess of the fair value of purchase consideration over the fair value of the assets acquired less liabilities assumed is recorded as goodwill. The Company uses management estimates based on historically similar transactions to assist in establishing the acquisition date fair values of assets acquired, liabilities assumed, and contingent consideration granted, if any. These estimates and valuations require the Company to make significant assumptions, including projections of future events and operating performance.

## Internal use software

Expenditures for major software purchases and software developed for internal use are capitalized and amortized over the useful life of the software (three to five years) on a straight-line basis. The Company's policy provides for the capitalization of external direct costs of materials and services associated with developing or obtaining internal-use computer software. Costs associated with preliminary project stage activities, training, maintenance, and all other post-implementation stage activities are expensed as incurred.

## Recently Issued Accounting Standards

### **Recently Adopted Accounting Standards**

#### *Revenue from Contracts with Customers*

The Company adopted ASU No. 2014-09, *Revenue from Contracts with Customers (Topic 606)* ("ASU 2014-09") as of January 2, 2018. The Company adopted the new standard using the full retrospective method and elected applicable practical expedients on adoption. Accordingly, previously reported financial information has been restated to reflect the application of the new standard to all comparative periods presented.

Adoption of ASU 2014-09 had a material impact on the Company's consolidated financial statements. The most significant impacts relate to the: (i) accounting for franchise and development fees, and (ii) accounting for the Company's advertising fund ("BMF") and Convention Fund (with the BMF, the "Brand Funds"). Specifically, under the new standard the Company recognizes franchise fees ratably over the life of the contract rather than at the time the store is opened or a successive contract commences. Revenue related to the Company's franchise royalties, which are based on a percentage of franchise sales, and revenue from Company-owned stores remain substantially unchanged.

The Company has determined that ASU 2014-09 requires a gross presentation on the Company's Consolidated Statements of Operations for revenues and related expenses of the Brand Funds. These funds exist solely for the purpose of promoting the Papa Murphy's brand in the U.S. While this change materially affects the gross amount of reported revenues and expenses, the effect generally is an offsetting increase to both revenues and expenses with no net effect on reported Operating Income (Loss) and Net Income (Loss).

Refer to *Impacts to Reported Results* below for more detailed effects of adoption on the Company's financial statements and refer to *Note 12 — Revenue* for more information on its accounting for revenue.

#### *Leases*

The Company early adopted ASU No. 2016-02, *Leases (Topic 842)* ("ASU 2016-02") as of January 2, 2018, concurrent with the adoption of the new revenue standard. The Company adopted this standard using the modified retrospective approach and elected the available practical expedients on adoption. Accordingly, previously reported financial information has been restated to reflect the application of the new standard to all comparative periods presented.

Adoption of the new standard has had a material impact on the Company's consolidated financial statements. The most significant impacts related to the (i) recognition of ROU assets and lease liabilities for operating leases, and (ii) changes in occupancy costs and impairment losses related to prior year store closures and impairments. ROU assets represent the Company's right to use an underlying asset for the lease term and lease liabilities represent the Company's obligation to make lease payments arising from the lease. A loss is recognized when the ROU asset is impaired in connection with the impairment of a store's assets due to economic or other factors.

Refer to *Impacts to Reported Results* below for more detailed effects of adoption on the Company's financial statements and refer to *Note 13 — Leases* for more information on its accounting for leases.

#### *Other standards adopted*

In August 2016, the FASB issued ASU No. 2016-15, *Statement of Cash Flows (Topic 320)* ("ASU 2016-15"), which clarifies the presentation of certain cash receipts and cash payments in the statement of cash flows. The Company adopted the

standard on January 2, 2018. Adoption of the new standard did not have a material impact on the Company's consolidated financial statements.

### Recent Accounting Pronouncements Not Yet Adopted

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles-Goodwill and Other: Simplifying the Test for Goodwill Impairment* ("ASU 2017-04"). The new standard simplifies how an entity measures goodwill impairment by removing the second step of the two-step quantitative goodwill impairment test. An entity will no longer perform a hypothetical purchase price allocation to measure goodwill impairment. Instead, impairment will be measured at the amount by which the carrying value exceeds the fair value of a reporting unit; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform a qualitative assessment of whether it is more-likely-than-not that a reporting unit's fair value is less than its carrying amount. ASU 2017-04 requires prospective adoption and is effective for the annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is still evaluating the impact of ASU 2017-04 on its financial position and results of operations.

In August 2018, the FASB issued ASU No. 2018-15 *Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract* ("ASU 2018-15") which aligns the requirements for capitalizing implementation costs in cloud computing arrangements with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. ASU 2018-15 is effective for annual and interim periods beginning after December 15, 2019, with early adoption permitted. Companies can choose to adopt the new guidance prospectively or retrospectively. The Company is still evaluating the impact of ASU 2018-15 on its financial position and results of operations.

### Impacts to Reported Results

Adoption of the standards related to revenue recognition and leases affected the Company's previously reported results as follows:

	Fiscal 2017 Income Statement			
	As Reported	New Revenue Standard Adjustment	New Lease Standard Adjustment	As Adjusted
<i>(in thousands, except earnings per share)</i>				
Total revenues <sup>(1)</sup>	\$ 118,661	\$ 29,847	\$ —	\$ 148,508
Store operating costs	72,927	(1,570)	(1,181)	70,176
Selling, general, and administrative <sup>(1)</sup>	33,869	30,737	(42)	64,565
Loss on disposal or impairment of property and equipment	15,680	—	2,680	18,360
(Benefit from) provision for income taxes	(19,543)	1,416	(383)	(18,509)
Net loss	(8)	(736)	(1,074)	(1,818)
Diluted earnings (loss) per share	0.00	(0.04)	(0.07)	(0.11)

(1) Recognition of advertising revenue and expense on a gross basis instead of a net basis by the Brand Funds comprised \$29.2 million of the revenue adjustment and \$30.7 million of the expense adjustment under the revenue standard. The revenue adjustment due to the change in method of recognizing franchise and development fees was \$0.7 million.

	Balance Sheet as of January 1, 2018			
	As Reported	New Revenue Standard Adjustment	New Lease Standard Adjustment	As Adjusted
<i>(in thousands)</i>				
Prepaid expenses and other current assets	\$ 2,671	\$ —	\$ (390)	\$ 2,281
Operating lease right of use assets	—	—	16,331	16,331
Unearned franchise and development fees	1,702	9,899	—	11,601
Accrued expenses and other current liabilities	13,139	(507)	(250)	12,382
Lease liabilities	—	—	19,678	19,678
Deferred tax liability, net	24,457	(2,319)	(313)	21,825
Other long-term liabilities	3,922	—	(2,218)	1,704
Accumulated deficit	(18,613)	(7,073)	(956)	(26,642)

Adoption of the standard related to revenue recognition did not materially affect cash from or used in operating, financing, or investing cash flows on the Company's consolidated cash flows statements.

## Note 3 — Acquisitions

### Acquisitions in 2018

In November 2018, Papa Murphy's Company Stores, Inc. ("PMCSI"), a wholly owned subsidiary of the Company, acquired certain assets used in the operation of two Papa Murphy's stores in the Dallas, Texas area from a franchise owner and refranchised the assets to another franchisee the same day (see Note 6 — *Divestitures* for related information). The total consideration paid was \$0.1 million and the value of assets acquired was \$0.1 million.

## Note 4 — Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following:

<i>(in thousands)</i>	2018	2017
Prepaid media production costs	\$ 724	\$ 376
Prepaid software and support	469	223
Prepaid occupancy related costs	136	159
Prepaid insurance	160	377
Taxes receivable	61	182
POS software licenses for resale	368	364
Assets held for sale	257	432
Advertising cooperative assets, restricted	(24)	4
Other	22	164
Total prepaid expenses and other current assets	<u>\$ 2,173</u>	<u>\$ 2,281</u>

Prepaid media development costs represent costs incurred for advertisements that have not aired.

Assets held for sale include assets from closed stores that the Company is actively marketing to new or existing franchisees.

## Note 5 — Property and Equipment

Property and equipment, net, consists of the following:

<i>(in thousands)</i>	2018	2017
Leasehold improvements	\$ 4,184	\$ 7,475
Restaurant equipment and fixtures	6,891	12,515
Office furniture and equipment	3,017	2,978
Software	8,923	7,917
Vehicles	—	6
Construction in progress	436	1,059
	<u>23,451</u>	<u>31,950</u>
Accumulated depreciation and amortization	(18,585)	(21,886)
Property and equipment, net	<u>\$ 4,866</u>	<u>\$ 10,064</u>

Depreciation expense amounted to \$2.9 million and \$5.8 million during fiscal 2018 and 2017, respectively.

During fiscal 2018, the Company transferred approximately \$3.0 million from fixed assets to assets held for sale as part of the Company's ongoing divestiture activity. See *Note 6 — Divestitures*.

As part of the Company's property and equipment impairment review, the Company recorded an impairment of \$0.1 million and \$4.4 million to its Company-owned store assets during fiscal 2018 and 2017, respectively.

The Company recognized impairment losses of \$0.2 million and \$2.3 million in fiscal 2018 and 2017, respectively, related to the closure of certain underperforming Company-owned stores.

## Note 6 — Divestitures

---

### Divestitures in 2018

On April 23, 2018, the Company completed the sale and refranchise of two Company-owned stores in Arkansas. On May 21, 2018 and June 25, 2018, respectively, the Company completed the sale and refranchise of ten Company-owned stores in the Denver, Colorado area and ten Company-owned stores in the Colorado Springs, Colorado area. On October 1, 2018 and November 6, 2018 the Company completed the sale and refranchise of seven and two Company-owned stores, respectively, in the Dallas, Texas area. The aggregate sale price for the 31 stores was \$7.8 million, paid in cash and a long-term receivable of \$0.5 million. The Company recognized a pre-tax loss from these dispositions of \$1.2 million. The Company recorded a contingent liability for marketing expenditures of \$1.5 million, of which \$0.4 million is recorded as accrued expenses and other current liabilities and \$1.1 million is recorded as other long-term liabilities on the Company's Consolidated Balance Sheets. In connection with the sale, the buyers paid \$450,000 in franchise fees. These dispositions did not meet the criteria for accounting as a discontinued operation.

### Divestitures in 2017

On May 1, 2017, the Company completed the sale and refranchise of six Company-owned stores in Colorado. On May 8, 2017, the Company completed the sale and refranchise of one Company-owned store in Colorado in an unrelated transaction. The aggregate sale price for the seven stores was \$2.2 million, paid in cash, and the Company recognized a pre-tax gain of \$0.1 million. In connection with the sale, the buyers paid \$0.3 million in franchise fees. The assets sold were classified as assets held for sale on the Company's Consolidated Balance Sheets. These dispositions did not meet the criteria for accounting as a discontinued operation.

## Note 7 — Goodwill

---

The following summarizes changes to the Company's goodwill by reportable segment:

<i>(in thousands)</i>	Company Stores	Franchise	Total
Balance at January 2, 2017	\$ 26,924	\$ 81,546	\$ 108,470
Disposition	(719)	—	(719)
Balance at January 1, 2018	26,205	81,546	107,751
Disposition	(5,988)	—	(5,988)
Balance at December 31, 2018	<u>\$ 20,217</u>	<u>\$ 81,546</u>	<u>\$ 101,763</u>

There is no goodwill associated with the Brand Funds segment. Based on the results of the Company's impairment testing, the Company did not recognize any impairment of goodwill during fiscal 2018 or 2017. The Company recorded Goodwill disposals in fiscal 2018 and 2017 from the sale of Company-owned stores to franchise owners (see *Note 6 — Divestitures*).

## Note 8 — Intangible Assets

Intangible assets consist of the following:

		2018			Weighted Average Amortization Period
<i>(in thousands)</i>		Gross Carrying Amount	Accumulated Amortization	Net	
Intangible assets subject to amortization:					
Franchise relationships		\$ 56,000	\$ (30,355)	\$ 25,645	16.0
Reacquired franchise rights		4,660	(2,979)	1,681	7.8
Net intangible assets subject to amortization		<u>\$ 60,660</u>	<u>\$ (33,334)</u>	<u>\$ 27,326</u>	15.4
Intangible assets not subject to amortization					
Trade name and trademarks				<u>\$ 87,002</u>	
		2017			Weighted Average Amortization Period
<i>(in thousands)</i>		Gross Carrying Amount	Accumulated Amortization	Net	
Intangible assets subject to amortization:					
Franchise relationships		\$ 56,000	\$ (26,855)	\$ 29,145	16.0
Reacquired franchise rights		5,887	(3,377)	2,510	6.8
Net intangible assets subject to amortization		<u>\$ 61,887</u>	<u>\$ (30,232)</u>	<u>\$ 31,655</u>	15.1
Intangible assets not subject to amortization					
Trade name and trademarks				<u>\$ 87,002</u>	

Reacquired franchise rights were recorded as part of the Company's acquisitions of franchised stores. Trade name and trademarks are intangible assets determined to have indefinite lives and are not subject to amortization. Management has concluded that none of its reporting units, with a material amount of intangible assets not subject to amortization, are at risk for failing step one of the quantitative assessment for impairment of intangible assets.

Amortization expense amounted to \$4.3 million and \$4.7 million for fiscal 2018 and 2017, respectively.

The estimated future amortization expense of amortizable intangible assets as of the end of fiscal 2018 is as follows (in thousands):

Fiscal year	2019	\$ 4,056
	2020	3,943
	2021	3,876
	2022	3,803
	2023	3,503
	Thereafter	8,145
		<u>\$ 27,326</u>

## Note 9 — Financing Arrangements

Long-term debt consists of the following:

<i>(in thousands)</i>	2018	2017
Term loan under credit facility	\$ 79,508	\$ 92,900
Notes payable	3,000	3,000
Total principal amount of long-term debt	82,508	95,900
Less unamortized debt issuance costs	(464)	(506)
Total long-term debt	82,044	95,394
Less current portion	(11,400)	(8,400)
Total long-term debt, net of current portion	<u>\$ 70,644</u>	<u>\$ 86,994</u>

Maturities on long-term debt consist of the following:

<i>(in thousands)</i>	Senior Secured Credit Facility	Notes Payable	Total
Fiscal Years 2019	\$ 8,400	\$ 3,000	\$ 11,400
2020	71,108	—	71,108
	<u>\$ 79,508</u>	<u>\$ 3,000</u>	<u>\$ 82,508</u>

The weighted average interest rate across all senior secured credit facilities for fiscal 2018 and 2017 was 6.01% and 4.34%, respectively.

### Senior secured credit facility

On August 28, 2014, PMI Holdings, Inc., a wholly-owned subsidiary of the Company, entered into a \$132.0 million senior secured credit facility (the "Credit Facility") consisting of a \$112.0 million term loan and a \$20.0 million revolving credit facility, which includes a \$2.5 million letter of credit sub-facility and a \$1.0 million swing-line loan sub-facility. Closing and structuring fees of \$1.6 million were incurred as a result of this transaction which will be amortized over the duration of the loan. The term loan and any loans made under the revolving credit facility were originally scheduled to mature in August 2019.

On November 6, 2018, PMI Holdings, Inc. entered into a second amendment to its Credit Facility. The amendment, among other things, extends the term of the Credit Facility by twelve months to August 2020 and reduces the revolving credit facility from \$20.0 million to \$7.5 million. In addition, the amendment increases the maximum leverage ratio, requires continuation of quarterly \$2.1 million installment payments through the new maturity date, and increases the applicable interest rate margins. Closing and structuring fees of \$0.3 million were incurred as a result of this transaction which will be amortized over the remaining duration of the loan.

Borrowings under the Credit Facility bear interest at a rate per annum equal to an applicable margin based on the Company's consolidated leverage ratio, plus, at the Company's option, either (a) a base rate determined by reference to the highest of (i) the "Prime Rate" publicly quoted by The Wall Street Journal, (ii) the federal funds rate plus 50 basis points, or (iii) the LIBOR rate with a one-month interest period plus 100 basis points, or (b) a LIBOR rate determined for the specified interest period. The applicable margin for borrowings under the Credit Facility, as amended by the second amendment to the credit facility, ranges from 200 to 300 basis points for base rate borrowings and 300 to 400 basis points for LIBOR rate borrowings. The Credit Facility includes customary fees for loan facilities of this type, including a commitment fee on the revolving credit facility. As of December 31, 2018, all \$79.5 million of the term loan was subject to the LIBOR rate option at 6.52%.

The obligations under the Credit Facility are guaranteed by certain domestic subsidiaries of the Company (the "subsidiary guarantors") and are secured by substantially all assets of the Company and the subsidiary guarantors. The Credit Facility also contains customary affirmative and negative covenants that are typical for loan facilities of this type, including covenants that, among other things, restrict the Company's ability and the ability of its subsidiaries to incur indebtedness, issue certain types of equity, incur liens, enter into fundamental changes, including mergers and consolidations, sell assets, make dividends, distributions and investments, and prepay subordinated indebtedness, subject to customary exceptions.

The Credit Facility also includes certain financial covenants with respect to a maximum consolidated leverage ratio, a minimum interest coverage ratio, and a fixed charge coverage ratio.

With a maturity date of over one year from December 31, 2018, balances outstanding under the Credit Facility are classified as non-current on the Consolidated Balance Sheets, except for mandatory, minimum term loan amortization payments of \$2.1 million due on the last day of each fiscal quarter.

## Notes payable

PMCSI has a note payable for \$3.0 million which bears interest at 5% and matures in January 2019. This note is subordinated to the senior secured credit facility.

## Deferred financing costs and prepayment penalties

In conjunction with the Credit Facility, the Company evaluated the refinancing of its prior credit facility and determined that the borrowing was extinguished and not modified. Accordingly, unamortized deferred financing costs of \$2.3 million from the prior credit facility and a prepayment penalty of \$1.1 million were expensed as a Loss on early retirement of debt in 2014. The Company incurred \$1.6 million in financing costs, which was capitalized and is being amortized using an effective interest rate method. The Company also incurred \$0.3 million in financing costs associated with the second amendment to the Credit Facility, which was also capitalized and is being amortized using an effective interest rate method.

Deferred financing costs amortized to interest expense in the Consolidated Statements of Operations amounted to \$0.3 million for fiscal years 2018 and 2017, respectively.

Amortization of deferred financing costs in the future is expected to be as follows (in thousands):

Fiscal Years 2019 .....	\$	287
2020 .....		177
	\$	<u>464</u>

## Note 10 — Fair Value Measurement

The Company determines the fair value of assets and liabilities based on the price that would be received to sell the asset or paid to transfer the liability to a market participant. GAAP defines a fair value hierarchy that prioritizes the assumptions used to measure fair value. The three levels of the fair value hierarchy are defined as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- Level 2 — Observable inputs other than prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated with observable market data
- Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies and similar techniques that use significant unobservable inputs.

The following table presents information about the Company's assets and liabilities measured at fair value on a recurring basis:

(in thousands)	2018		2017		Fair Value Measurements
	Carrying Value	Fair Value	Carrying Value	Fair Value	
<b>Financial assets</b>					
Notes receivable <sup>(1)</sup> .....	\$ —	\$ —	\$ 97	\$ 88	Level 3
Other receivables <sup>(1)</sup> .....	505	439	—	—	Level 3

(1) The fair value of notes receivable and other receivables was estimated primarily using a discounted cash flow method based on a discount rate, reflecting the applicable credit spread.

Financial instruments not included in the table above consist of cash and cash equivalents, accounts receivable, accounts payable, and long-term debt. The fair value of cash and cash equivalents, accounts receivable, and accounts payable approximates carrying value because of the short-term nature of the accounts. The fair value of long-term debt approximates carrying value because the borrowings are made with variable market rates and negotiated terms and conditions that are consistent with current market rates.

## Note 11 — Accrued and Other Liabilities

Accrued expenses and other current liabilities consist of the following:

<i>(in thousands)</i>	2018	2017
Accrued compensation and related costs . . . . .	\$ 4,100	\$ 3,902
Accrued legal settlement costs . . . . .	2,363	3,940
Gift cards and certificates payable . . . . .	2,700	2,676
Accrued interest and non-income taxes payable . . . . .	318	461
Convention fund balance . . . . .	1,175	841
Advertising cooperative liabilities . . . . .	25	60
Lease liabilities held for sale . . . . .	763	—
Other . . . . .	945	502
Total accrued expenses and other current liabilities	<u>\$ 12,389</u>	<u>\$ 12,382</u>

Accrued legal settlement costs decreased since January 1, 2018 due to \$1.8 million in payments to partially settle the TCPA class action lawsuit and \$3.3 million in payments to settle franchise litigation claims that reduced the \$3.7 million accrual for legal settlement costs related to the franchise litigation recorded in the current year. Both lawsuits are discussed in more detail in *Note 17 — Commitments and Contingencies*. Included in Accounts receivable, net is an insurance receivable equal to 75% of the anticipated settlement of the franchise owner lawsuit.

## Note 12 — Revenue

### Revenue by Category

The following series of tables present revenue disaggregated by several categories for the periods reported.

Revenues by contract type were as follows:

<i>(in thousands)</i>	2018			
	Franchise	Company Stores	Brand Funds	Total
Franchise royalties . . . . .	\$ 36,234	\$ —	\$ 14,677	\$ 50,911
Franchise fees . . . . .	2,891	—	—	2,891
Vendor payments . . . . .	—	—	5,008	5,008
E-commerce fees . . . . .	2,384	—	—	2,384
Other franchise and brand . . . . .	99	—	3,360	3,459
Company-owned stores . . . . .	—	61,776	—	61,776
Total revenues . . . . .	<u>41,608</u>	<u>61,776</u>	<u>23,045</u>	<u>126,429</u>
Intersegment revenues . . . . .	3,256	—	1,591	4,847
Reconciliation to business segment revenues . . . . .	<u>\$ 44,864</u>	<u>\$ 61,776</u>	<u>\$ 24,636</u>	<u>\$ 131,276</u>

	2017			
<i>(in thousands)</i>	Franchise	Company Stores	Brand Funds	Total
Franchise royalties	\$ 37,552	\$ —	\$ 22,189	\$ 59,741
Franchise fees	2,907	—	—	2,907
Vendor payments	—	—	4,524	4,524
E-commerce fees	1,936	—	—	1,936
Other franchise and brand	85	—	2,447	2,532
Company-owned stores	—	76,868	—	76,868
Total revenues	42,480	76,868	29,160	148,508
Intersegment revenues	227	—	1,707	1,934
Reconciliation to business segment revenues	<u>\$ 42,707</u>	<u>\$ 76,868</u>	<u>\$ 30,867</u>	<u>\$ 150,442</u>

Revenues by geographic location were as follows:

	2018			
<i>(in thousands)</i>	Franchise	Company Stores	Brand Funds	Total
United States	\$ 41,280	\$ 61,776	\$ 23,045	\$ 126,101
International	328	—	—	328
Total revenues	<u>\$ 41,608</u>	<u>\$ 61,776</u>	<u>\$ 23,045</u>	<u>\$ 126,429</u>

	2017			
<i>(in thousands)</i>	Franchise	Company Stores	Brand Funds	Total
United States	\$ 42,084	\$ 76,868	\$ 29,160	\$ 148,112
International	396	—	—	396
Total revenues	<u>\$ 42,480</u>	<u>\$ 76,868</u>	<u>\$ 29,160</u>	<u>\$ 148,508</u>

## Contract Balances

Changes in the balances of contract liabilities (unearned revenue) during the periods reported were as follows:

<i>(in thousands)</i>	Contract Liabilities
Balance at January 1, 2018	\$ 11,151
Revenue recognized that was included in the balance at the beginning of the period	(2,718)
Cash received, net of amounts recognized as revenue during the period	1,775
Contract refunds	(330)
Balance at December 31, 2018	<u>\$ 9,878</u>

The Company had a refund liability of \$0.5 million as of December 31, 2018 and January 1, 2018, respectively. Receivables from contracts with customers included in Accounts receivable, net were \$3.1 million and \$3.8 million as of December 31, 2018 and January 1, 2018, respectively.

The following table includes estimated franchise fee revenue expected to be recognized in the future related to performance obligations that were unsatisfied (or partially unsatisfied) as of December 31, 2018 (in thousands):

Fiscal year	2019	\$ 1,623
	2020	1,488
	2021	1,331
	2022	1,170
	2023	937
	Thereafter	3,329
	Total	<u>\$ 9,878</u>

## Note 13 — Leases

The components of lease expense for the periods reported are as follows:

<i>(in thousands)</i>	2018	2017
Operating lease cost	\$ 3,789	\$ 5,068
Short-term lease cost	45	22
Variable lease cost	16	34
Sublease income	(60)	(66)
<b>Total lease cost</b>	<b>\$ 3,790</b>	<b>\$ 5,058</b>

Supplemental cash flow information related to leases for the periods reported is as follows:

<i>(in thousands)</i>	2018	2017
<b>Cash paid for amounts included in the measurement of lease liabilities:</b>		
Operating cash flows from operating leases	\$ 4,410	\$ 4,871
Right-of-use assets obtained in exchange for new operating lease liabilities	926	213
Weighted-average remaining lease term of operating leases	5.3 years	5.9 years
Weighted-average discount rate of operating leases	6.0%	6.0%

Future minimum lease payments under non-cancelable leases as of December 31, 2018 are as follows (in thousands):

Fiscal year	2019	\$ 4,104
	2020	3,509
	2021	2,580
	2022	1,913
	2023	1,490
	Thereafter	2,655
	<b>Total future minimum lease payments</b>	<b>16,251</b>
	Less imputed interest	(2,804)
	Less lease liabilities held for sale <sup>(1)</sup>	(2,131)
	<b>Total Lease Liabilities</b>	<b>\$ 11,316</b>

(1) Lease liabilities held for sale includes \$0.8 million reported in Accrued expenses and other current liabilities (see Note 11 — Accrued and Other Liabilities) and \$1.4 million reported in Other long-term liabilities in the Company's Consolidated Balance Sheets.

As of December 31, 2018, the Company had no operating leases that had not yet commenced.

### Lease guarantees

The Company is the guarantor for operating leases of 40 franchised stores that have terms expiring on various dates from February 2019 to April 2025. The obligations from these leases will generally continue to decrease over time as the leases expire. The applicable franchise owners continue to have primary liability for these operating leases. During 2018, the Company was required to perform under one of these guarantees when a franchisee declared bankruptcy and defaulted on its obligations. As a result, the Company recorded a loss contingency of \$170,000 for 2018. As of December 31, 2018, the Company does not believe it probable that it would be required to perform under any of the remaining guarantees.

As of the end of fiscal 2018, future commitments under these leases are as follows (in thousands):

Fiscal Years	2019	\$	1,133
	2020		900
	2021		486
	2022		240
	2023		181
	Thereafter		56
		<u>\$</u>	<u>2,996</u>

## Note 14 — Income Taxes

In December 2017, the Tax Cuts and Jobs Act (the “2017 Tax Act”) was enacted. The 2017 Tax Act includes a number of changes to existing U.S. tax laws that affect the Company, most notably a reduction of the top U.S. corporate income tax rate from 35% to 21% for tax years beginning after December 31, 2017. The 2017 Tax Act also provides for the acceleration of depreciation for certain assets placed into service after September 27, 2017 as well as prospective changes beginning in 2018, including additional limitations on the deductibility executive compensation and interest.

The Company recognized the income tax effects of the 2017 Tax Act in its 2017 financial statements in accordance with Staff Accounting Bulletin No. 118, which provides SEC staff guidance for the application of ASC Topic 740 *Income Taxes* in the reporting period in which the 2017 Tax Act was signed into law.

As of December 31, 2018 the Company has completed its accounting for all enactment-date tax effects of the 2017 Tax Act and current period adjustments related to these items were immaterial.

The components of the provision for (benefit from) income taxes are as follows:

<i>(in thousands)</i>	2018	2017
<b>Current tax provision</b>		
Federal .....	\$ 10	\$ 9
State .....	177	171
	<u>187</u>	<u>180</u>
<b>Deferred tax provision (benefit)</b>		
Federal .....	1,156	(17,790)
State .....	140	(899)
	<u>1,296</u>	<u>(18,689)</u>
<b>Total provision for (benefit from) income taxes</b> .....	<u>\$ 1,483</u>	<u>\$ (18,509)</u>

The components of the non-current deferred tax liability are as follows:

<i>(in thousands)</i>	2018	2017
<b>Deferred income tax assets:</b>		
Unearned franchise and development fees . . . . .	\$ 1,816	\$ 2,565
Convention and Advertising funds balance . . . . .	255	208
Compensation accruals . . . . .	652	449
Gift card accruals . . . . .	134	348
Asset retirement obligation . . . . .	52	120
Lease obligations . . . . .	700	596
Share-based compensation . . . . .	838	769
Net operating loss . . . . .	158	1,013
Other . . . . .	700	213
<b>Total deferred tax assets . . . . .</b>	<b>5,305</b>	<b>6,281</b>
Valuation allowance . . . . .	(134)	(98)
<b>Total deferred tax assets after valuation allowance . . . . .</b>	<b>5,171</b>	<b>6,183</b>
<b>Deferred income tax liabilities:</b>		
Fixed asset, goodwill, and intangible asset basis differences . . . . .	(26,283)	(27,273)
Other . . . . .	(2,009)	(735)
<b>Total deferred tax liabilities . . . . .</b>	<b>(28,292)</b>	<b>(28,008)</b>
<b>Net deferred tax liability . . . . .</b>	<b>\$ (23,121)</b>	<b>\$ (21,825)</b>

As of the end of fiscal 2018, the Company had state net operating loss carry forwards of \$3.0 million. As of the end of fiscal 2017, the Company had federal and state net operating loss carry forwards of \$3.8 million and \$5.0 million, respectively. The state net operating loss carry forwards begin to expire in 2020. As of the end of fiscal 2018, the Company has federal and state credit carryovers of \$0.5 million that are a combination of credits that begin to expire in 2035.

Tax benefits for federal and state net operating loss carry forwards are recorded as an asset to the extent that management assesses the utilization of such assets to be “more likely than not”; otherwise, a valuation allowance is required to be recorded. The Company has looked to future reversals of existing taxable temporary differences in determining that its federal and a majority of its state net operating loss carry forwards are more likely than not to be utilized prior to their expiration dates. Consequently, no valuation allowance has been recorded for these deferred tax assets. Several separate filing states where the Company operates have facts that indicate it is more likely that the Company will not utilize the separate filing state carryovers prior to their expiration dates. As of the end of fiscal 2018, the Company has recorded a \$134,000 valuation allowance for these particular carryovers. The Company will continue to evaluate the need for a valuation allowance in the future. Changes in estimated future taxable income and other underlying factors may lead to adjustments to the valuation allowance in the future.

As of the end of fiscal 2018, the Company had \$77,000 of unrecognized tax benefits that, if recognized, would affect the effective tax rate. A reconciliation of the beginning and ending liability for unrecognized tax benefits excluding interest and penalties is as follows (in thousands):

Balance as of the end of fiscal 2017 . . . . .	\$ 77
Additions for tax positions of prior years . . . . .	—
<b>Balance as of the end of fiscal 2018 . . . . .</b>	<b>\$ 77</b>

A reconciliation of income tax at the United States federal statutory tax rate (using a statutory tax rate of 21% and 34%) to income tax expense for the periods reported is as follows:

<i>(in thousands)</i>	2018	2017
Federal income tax provision based on statutory rate	\$ 1,219	\$ (6,899)
State and local income tax effect	250	(481)
Impact of change in tax rates	—	(11,300)
Non-deductible expenses	62	203
Tax credits and other	(48)	(32)
Provision for (benefit from) income taxes	<u>\$ 1,483</u>	<u>\$ (18,509)</u>

## Note 15 — Share-based Compensation

In May 2010, the Company's Board of Directors approved the 2010 Plan. In May 2014, the Company's Board of Directors adopted the 2014 Plan (together with the 2010 Plan, the "Incentive Plans"). The Incentive Plans reserve 2,116,747 common shares for equity incentive awards consisting of incentive stock options, non-qualified stock options, restricted stock awards, and unrestricted stock awards. Equity incentive awards may be issued from either the 2010 Plan or the 2014 Plan.

### Restricted common shares

Under the Incentive Plans, restricted common stock awards are subject to either time-vesting or market conditions. Time-vesting restricted common stock awards issued under the 2010 Plan have generally vested 20% on each of the five anniversaries of the sale date. Time-vesting restricted common stock awards granted under the 2014 Plan have generally vested 100% on either the one-year or three-year anniversary of the grant date. Prior to fiscal 2017, market condition restricted common stock awards were scheduled to vest when the volume-weighted average closing price per share of the Company's common stock equals or exceeds \$22.00 per share for 90 consecutive trading days. In fiscal 2017, the vesting condition for market condition restricted common stock was modified to vest when the volume-weighted average closing price per share of the Company's common stock equals or exceeds \$14.50 per share for 90 consecutive trading days. To the extent the fair value of an award on the date of the sale, grant, or modification exceeds the sale price, if any, the excess is recognized as compensation expense as a component of selling, general, and administrative expenses. Compensation expense for time-vesting restricted common stock awards is recognized over the requisite service period on a straight-line basis.

The Company has a right to repurchase shares sold to employees under the 2010 Plan in the case of a qualifying sale, bankruptcy event, or a termination of employment or service of the employee who purchased shares, including a voluntary termination. Unvested shares as of the date of these events are repurchased at the original sale price. The Company generally does not repurchase vested shares from terminated employees.

Information with respect to restricted stock awards is as follows:

	Number of Shares of Restricted Common Stock		Weighted Average Award Date Fair Value per Share
	Time Vesting	Market Condition	
Unvested, January 1, 2018	34,898	40,354	\$ 3.44
Granted	41,000	—	5.33
Vested	(34,898)	—	4.82
Forfeited/Repurchased	—	(10,183)	3.80
Unvested, December 31, 2018	<u>41,000</u>	<u>30,171</u>	<u>\$ 3.79</u>

Fair value information for restricted stock awards during the periods reported is as follows:

<i>(in thousands, except per share amounts)</i>	2018	2017
Weighted average grant date fair value per share . . . . .	\$ 5.33	\$ 4.65
Total fair value of shares issued . . . . .	\$ 218	\$ 164
Total fair value of shares vested . . . . .	\$ 168	\$ 697

## Stock options

Under the Incentive Plans, stock options are subject to either time-vesting or market conditions. Time-vesting stock options generally vest 25% on each of the four anniversaries of the grant date. Prior to fiscal 2017, market condition stock options were scheduled to vest when the volume-weighted average closing price per share of the Company's common stock equals or exceeds \$22.00 per share for 90 consecutive trading days. In fiscal 2017, the vesting condition for market condition stock options was modified to vest when the volume-weighted average closing price per share of the Company's common stock equals or exceeds \$14.50 per share for 90 consecutive trading days. The grant date fair value and any additional fair value from modification of an award are recognized as compensation expense as a component of selling, general, and administrative expenses. The compensation expense is recognized over the requisite service period, typically the vesting period, on a straight line basis.

Information with respect to stock option activity is as follows:

	Number of Shares Subject to Stock Options		Weighted Average Exercise Price per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
	Time Vesting	Market Condition			
Outstanding, January 1, 2018 . . . . .	949,115	158,127	\$ 7.60		
Granted . . . . .	210,700	—	5.12		
Exercised . . . . .	(22,750)	—	3.99		
Forfeited . . . . .	(333,721)	(46,837)	7.34		
Outstanding, December 31, 2018 . . . . .	803,344	111,290	\$ 7.23	7.8 years	\$ 121
Exercisable, December 31, 2018. . . . .	395,928	—	\$ 9.11	6.7 years	\$ 51

Fair value information for stock options granted and vested and the intrinsic value of stock options exercised during the periods reported are as follows:

<i>(in thousands, except per share amounts)</i>	2018	2017
Weighted average grant date fair value per share . . . . .	\$ 1.76	\$ 1.66
Total fair value of awards granted . . . . .	\$ 370	\$ 1,179
Total fair value of awards vested . . . . .	\$ 435	\$ 422
Total intrinsic value of stock options exercised . . . . .	\$ 32	\$ —

## Compensation cost and valuation

Total compensation costs recognized in connection with the Incentive Plans for fiscal 2018 and 2017 amounted to \$0.5 million and \$0.7 million, respectively. Additionally, the associated income tax benefits for each of fiscal 2018 and 2017 amounted to \$0.1 million.

As of the end of fiscal 2018, the total unrecognized share-based compensation expense was \$1.0 million, with \$0.7 million associated with time-vesting awards and \$0.2 million associated with market condition awards. The remaining weighted average period for unrecognized share-based compensation expense was 2.2 years as of the end of fiscal 2018.

The fair value of the stock option awards granted during the periods reported was estimated with the following weighted-average assumptions.

	2018	2017
Risk free rate . . . . .	2.40%	2.00%
Expected volatility . . . . .	24.4%	25.8%
Expected term . . . . .	5.1 years	5.5 years
Expected dividend yield . . . . .	0.0%	0.0%

## Note 16 — Earnings per Share (EPS)

The number of shares and earnings per share (“EPS”) data for all periods presented are based on the historical weighted-average shares of common stock outstanding.

Basic EPS is calculated by dividing income available to common stockholders by the weighted-average number of shares of common stock outstanding during each period. Diluted EPS is calculated using income available to common stockholders divided by diluted weighted-average shares of common stock outstanding during each period, which includes unvested restricted common stock and outstanding stock options. Diluted EPS considers the effect of potentially dilutive securities except in periods in which there is a loss because the inclusion of the potential common shares would have an anti-dilutive effect.

The following table sets forth the computations of basic and diluted EPS:

<i>(in thousands, except per share data)</i>	2018	2017
Earnings:		
Net income (loss) . . . . .	\$ 4,324	\$ (1,818)
Preferred dividends . . . . .	—	—
Net income (loss) available to common shareholders . . . . .	<u>\$ 4,324</u>	<u>\$ (1,818)</u>
Shares:		
Basic weighted average common shares outstanding . . . . .	16,930	16,870
Dilutive effect of restricted equity awards <sup>(1)</sup> . . . . .	71	—
Diluted weighted average number of shares outstanding . . . . .	<u>17,001</u>	<u>16,870</u>
Earnings (loss) per share:		
Basic earnings (loss) per share . . . . .	<u>\$ 0.26</u>	<u>\$ (0.11)</u>
Diluted earnings (loss) per share . . . . .	<u>\$ 0.25</u>	<u>\$ (0.11)</u>

(1) An aggregated total of 661,000 and 901,000 potential common shares have been excluded from the diluted EPS calculation for 2018 and 2017, respectively, because their effect would have been anti-dilutive.

## Note 17 — Commitments and Contingencies

### Legal proceedings

The Company is from time to time involved in litigation, certain other claims and arbitration matters arising in the ordinary course of business. The Company accrues a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of the probability of a loss and the determination as to whether a loss is reasonably estimable. These accruals are reviewed at least quarterly and adjusted to reflect the effects of negotiations, settlements, rulings, advice of legal counsel and technical experts and other information and events pertaining to a particular matter. To the extent there is a reasonable possibility (within the meaning of Accounting Standards Codification (“ASC”) 450) that losses could exceed amounts already accrued, if any, and the additional loss or range of loss is able to be estimated, the Company discloses the additional loss or range of loss.

In some instances, the Company is unable to reasonably estimate any potential loss or range of loss. The nature and progression of litigation can make it difficult to predict the impact a particular lawsuit will have on its business. There are many reasons that the Company cannot make these assessments, including, among others, one or more of the following: the early stages of a proceeding; damages sought that are unspecified, unsupported, unexplained or uncertain; discovery

not having been started or incomplete; the complexity of the facts that are in dispute; the difficulty of assessing novel claims; the parties not having engaged in any meaningful settlement discussions; the possibility that other parties may share in any ultimate liability; and/or the often slow pace of litigation.

The Company is currently subject to litigation with a group of franchise owners. In January 2014, six franchise owner groups claimed that the Company misrepresented sales volumes, made false representations to them, and charged excess advertising fees, among other things. The Company engaged in mediation with these franchise owners, which is required under the terms of their franchise agreements, in order to address and resolve their claims, but was unable to reach a settlement agreement. On April 4, 2014, a total of twelve franchise owner groups, including those franchise owners that previously made the allegations described above, filed a lawsuit against the Company in the Superior Court in Clark County, Washington, making essentially the same allegations for violation of the Washington Franchise Investment Protection Act, fraud, negligent misrepresentation and breach of contract and seeking declaratory and injunctive relief, as well as monetary damages. Based on motions filed by the Company in that lawsuit, the court ruled on July 9, 2014 that certain of the plaintiffs' claims under the anti-fraud and nondisclosure provisions of the Washington Franchise Investment Protection Act should be dismissed and that certain other claims in the case would need to be more specifically alleged. The court also ruled that the six franchise owner groups who had not mediated with the Company prior to filing the lawsuit must mediate with the Company in good faith, and that their claims shall be stayed until they have done so.

On June 18, 2014, an additional 16 franchise owner groups, represented by the same counsel as the plaintiffs described above, filed a lawsuit in the Superior Court in Clark County, Washington making essentially the same allegations as made in the lawsuit described above and seeking declaratory and injunctive relief, as well as monetary damages. The court consolidated the two lawsuits into a single case and ordered that the plaintiffs in the new lawsuit, none of whom had mediated with the Company prior to filing the lawsuit, must do so, and that their claims be stayed until they completed mediating with the Company in good faith.

In October 2014, the Company engaged in mediation with the 22 franchise owner groups who had not previously done so. As a result of that mediation and other efforts, the Company has now reached resolution with 13 of the franchise owner groups involved in the consolidated lawsuits, and their claims have either been dismissed or dismissal is pending.

In February 2015, the remaining franchise owner groups in the consolidated lawsuits filed an amended complaint, removing some claims, amending some claims, adding claims and naming some of the Company's former and current franchise sales staff as additional individual defendants. In September 2016, the remaining 15 franchise owner groups in the consolidated lawsuits filed an amended complaint to add a claim under the Washington Consumer Protection Act based on substantially the same allegations as the prior claims, to re-plead claims under the Washington Franchise Investment Protection Act that had previously been dismissed, and to dismiss Dan Harmon as a defendant.

In June 2017, the parties moved for summary judgment. The Company moved for summary judgment against two of the remaining franchise owner groups, the board of directors members moved for summary judgment on all claims against them, and the plaintiffs moved for summary judgment against all defendants on their Washington Consumer Protection Act and Washington Franchise Investment Protection Act claims. A hearing on the summary judgment motions was held on October 13, 2017.

In July 2017, the Company engaged in mediation with the remaining 15 franchise owner groups in the consolidated lawsuits. As a result of that mediation and other efforts, the Company reached resolutions with six of the remaining franchise owner groups, and their claims have been dismissed.

In April 2018, the Company reached resolution with four of the remaining franchise owner groups, conditioned upon dismissal of their claims.

In June 2018, the Company reached resolution with an additional franchise owner group.

On June 29, 2018, the Court granted the Company's motion to strike the remaining franchise owner groups' jury demand. The Court denied the Company's motion for separate trials, because at the time of the hearing there were only two franchise owner groups remaining in the case, based on tentative settlements with two other groups.

In July 2018, the Company finalized the tentative settlements with two of the aforementioned franchise owner groups.

In September 2018, the Company reached resolution with an additional franchise owner group.

One franchise owner group remains in the case, with a trial scheduled to start in the spring of 2019.

As before, the Company believes the allegations in this litigation lack merit and, for the remaining plaintiff, the Company will continue to vigorously defend its interests, including by asserting a number of affirmative defenses and, where appropriate, counterclaims. The Company provides no assurance that it will be successful in its defense of the remaining lawsuit;

however, the Company does not currently expect the cost of resolving it to have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

The Company is named the defendant in a putative collective action filed by plaintiff Amanda Cottle on January 8, 2019, in the United States District Court for the Middle District of Florida. The lawsuit alleges that the Company violated the FLSA by failing to pay proper overtime wages to the plaintiff, a store manager. Ms. Cottle asks that the court certify the putative class and that unpaid wages and liquidated damages under the FLSA, as well as interest and fees, be awarded to her and each class member. The Company believes the allegations in this litigation lack merit and will vigorously defend its interests in the matter. The Company provides no assurance that it will be successful in its defense of this lawsuit; however, the Company does not currently expect the cost of resolving it to have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

In January 2019, the United States District Court for the Western District of Washington issued the final order and mandate releasing all claims relating to the putative class action lawsuit filed against us by plaintiff John Lennartson on May 7, 2015, alleging the Company failed to comply with the requirements of the Telephone Consumer Protection Act when it sent SMS text messages to consumers.

In addition to the foregoing, the Company is subject to routine legal proceedings, claims and litigation in the ordinary course of its business. The Company may also engage in future litigation with franchise owners to enforce the terms of franchise agreements and compliance with the Company's standards as determined necessary to protect the Company's brand, the consistency of products and the customer experience. Lawsuits require significant management attention and financial resources and the outcome of any litigation is inherently uncertain. The Company does not, however, currently expect that the costs to resolve these routine matters will have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

## Note 18 — Retirement Plans

The Company has a defined contribution benefit plan, qualified under Section 401(k) of the Internal Revenue Code (the "401(k) Plan"), covering all eligible employees. 401(k) Plan participants may receive up to a 4% matching contribution up to the limits established by the plan and by the Internal Revenue Service and are vested immediately. Contributions to the 401(k) Plan by the Company during fiscal 2018 and 2017 amounted to \$0.4 million.

## Note 19 — Brand Marketing Fund

The Company manages the BMF on behalf of all Papa Murphy's stores in the United States. The Company is committed under its franchise and other agreements to spend revenues of the BMF on marketing, creative efforts, media support, or related purposes specified in the agreements. Contributions to the BMF are recognized as revenue, while expenditures are included in selling, general, and administrative expenses. Expenditures of the BMF are primarily amounts paid to third-parties, but may also include personnel expenses and allocated costs. At each reporting date, to the extent contributions to the BMF exceed expenditures on a cumulative basis, the excess contributions are recorded in accrued expenses in the Company's Consolidated Balance Sheets. While no profit is recognized on amounts received by the BMF, when expenditures exceed contributions to the BMF on a cumulative basis, income from operations and net income may be affected due to the timing of when revenues are received and expenses are incurred.

Information on the Company's BMF balances for the periods reported is as follows:

<i>(in thousands)</i>	2018	2017
Opening fund (deficit) surplus . . . . .	\$ (5,461)	\$ (1,071)
Net activity during the period . . . . .	38	(4,390)
Ending fund deficit . . . . .	<u>\$ (5,423)</u>	<u>\$ (5,461)</u>

As of December 31, 2018, previously recognized expenses of \$5.4 million may be recovered in future periods if subsequent BMF contributions exceed expenditures.

## Note 20 — Segment Information

As a result of changes in the Company's executive management responsibilities, effective January 2, 2018, the Company changed its reportable segments by combining its domestic and international franchise business into a single Franchise segment and separating its Brand Funds business into a separate reportable segment. No changes were made to the Company's Company Stores segment. Management believes this change better reflects the priorities and decision making analysis around the allocation of the Company's resources. Prior period results for the affected segments have been retrospectively revised to reflect this change.

The Company now has the following reportable segments: (i) Franchise; (ii) Company Stores; and (iii) Brand Funds. The Franchise segment includes operations with respect to franchised stores and derives its revenues primarily from franchise and development fees and franchise royalties from franchised stores. The Company Stores segment includes operations with respect to Company-owned stores and derives its revenues from retail sales of pizza and side items to the general public. The Brand Funds segment includes the BMF and the Company's Convention Fund.

The Company measures the performance of its segments based on segment adjusted EBITDA and allocates resources based primarily on this measure. "EBITDA" is calculated as net income (loss) before interest expense, income taxes, depreciation, and amortization. Segment adjusted EBITDA excludes certain unallocated and corporate expenses. Although segment adjusted EBITDA is not a measure of financial condition or performance determined in accordance with GAAP, the Company uses segment adjusted EBITDA to compare the operating performance of its segments on a consistent basis and to evaluate the performance and effectiveness of its operational strategies. The Company's calculation of segment adjusted EBITDA may not be comparable to that reported by other companies.

The following tables summarize information on revenues, segment adjusted EBITDA, depreciation and amortization, interest expense (income), and assets for each of the Company's reportable segments and include a reconciliation of segment adjusted EBITDA to income (loss) before income taxes:

<i>(in thousands)</i>	Revenues	
	2018	2017
Franchise segment	\$ 44,864	\$ 42,707
Brand Funds segment	24,636	30,867
Intersegment eliminations	(4,847)	(1,934)
Franchise related	64,653	71,640
Company Stores segment	61,776	76,868
Total	126,429	148,508

The following table summarizes revenues by geographic area:

<i>(in thousands)</i>	Revenues	
	2018	2017
United States	\$ 126,101	\$ 148,112
International	328	396
Total	\$ 126,429	\$ 148,508

(in thousands)	Segment Adjusted EBITDA	
	2018	2017
Franchise	\$ 25,673	\$ 25,682
Company Stores	884	2,685
Brand Funds	169	(450)
Total reportable segments adjusted EBITDA	26,726	27,917
Corporate and unallocated	(4,420)	(7,417)
Depreciation and amortization	(7,241)	(10,452)
Interest expense, net	(5,212)	(5,078)
CEO transition and restructuring <sup>(1)</sup>	(595)	(2,614)
E-commerce impairment <sup>(2)</sup>	(350)	(9,085)
Store closures and impairments <sup>(3)</sup>	(1,918)	(9,145)
Litigation settlements <sup>(4)</sup>	(908)	(4,453)
Strategic alternatives <sup>(5)</sup>	(237)	—
Debt refinancing <sup>(6)</sup>	(38)	—
Income (Loss) Before Income Taxes	\$ 5,807	\$ (20,327)

- (1) Represents non-recurring management transition and restructuring costs in connection with the recruitment of a new Chief Executive Officer and other executive positions.
- (2) Represents impairment charges on the write-down of the Company's e-commerce platform based on the decision to move to a third-party developed and hosted solution and non-recurring costs incurred to complete the transition.
- (3) For 2018, represents primarily net losses on the refranchising of Company-owned stores primarily from the recording of contingent liabilities for committed marketing support expenditures in addition to impairments for Company-owned stores held for sale. For 2017, represents primarily non-cash charges associated with the impairment and disposal of store assets upon the decision to close stores.
- (4) Accruals made toward litigation reserves.
- (5) Reflects costs associated with the exploration of strategic alternatives.
- (6) Reflects costs associated with amendments to the Company's credit facilities.

(in thousands)	Depreciation and amortization	
	2018	2017
Franchise	\$ 4,644	\$ 5,921
Company Stores	2,597	4,531
Total	\$ 7,241	\$ 10,452

(in thousands)	Total Assets	
	2018	2017
Franchise	\$ 120,611	\$ 121,180
Company Stores	38,177	53,226
Brand Funds	873	509
Other <sup>(1)</sup>	87,063	87,200
Total	\$ 246,724	\$ 262,115

- (1) Other assets which are not allocated to the individual segments primarily include trade names & trademarks.

All long-lived assets are held within the United States.

## Note 21 — Subsequent Events

During January 2019, the note payable for \$3.0 million held by PMCSI was paid in full (see Note 9 — Financing Arrangements).

During January 2019, the Company made a \$1.9 million payment in connection with the final settlement of its TCPA class action lawsuit (see Note 11 — Accrued and Other Liabilities).

## Schedule 2

# PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements

### Papa Murphy's Holdings, Inc. and Subsidiaries

#### Unaudited Condensed Consolidated Statements of Operations

<i>(In thousands, except share and per share data)</i>	Three Months Ended	
	April 1, 2019	April 2, 2018
<b>Revenues</b>		
Franchise related . . . . .	\$ 16,149	\$ 16,190
Company-owned stores . . . . .	12,823	18,582
Total revenues . . . . .	28,972	34,772
<b>Costs and Expenses</b>		
Store operating costs:		
Cost of food and packaging . . . . .	4,194	6,126
Compensation and benefits . . . . .	4,181	5,631
Advertising . . . . .	928	1,252
Occupancy and other store operating costs . . . . .	2,509	3,103
Selling, general, and administrative . . . . .	11,759	13,013
Depreciation and amortization . . . . .	1,478	2,141
Loss on disposal or impairment of property and equipment . . . . .	21	2
Total costs and expenses . . . . .	25,070	31,268
<b>Operating Income</b> . . . . .	3,902	3,504
Interest expense, net . . . . .	1,397	1,292
Other expense, net . . . . .	45	51
<b>Income Before Income Taxes</b> . . . . .	2,460	2,161
Provision for income taxes . . . . .	654	581
<b>Net Income</b> . . . . .	\$ 1,806	\$ 1,580
<b>Earnings per share of common stock</b>		
Basic . . . . .	\$ 0.11	\$ 0.09
Diluted . . . . .	\$ 0.11	\$ 0.09
<b>Weighted average common stock outstanding</b>		
Basic . . . . .	16,956,044	16,905,738
Diluted . . . . .	16,992,704	16,944,894

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Balance Sheets

(In thousands, except par value and share data)

	April 1, 2019	December 31, 2018
<b>ASSETS</b>		
<b>Current Assets</b>		
Cash and cash equivalents	\$ 366	\$ 5,766
Accounts receivable, net	2,790	3,564
Inventories	547	549
Prepaid expenses and other current assets	2,443	2,173
Total current assets	6,146	12,052
Property and equipment, net	4,406	4,866
Operating lease right of use assets	9,441	9,801
Goodwill	101,763	101,763
Trade name and trademarks	87,002	87,002
Definite-life intangibles, net	26,296	27,326
Assets held for sale	3,015	3,117
Other assets	926	797
Total assets	<u>\$ 238,995</u>	<u>\$ 246,724</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Current Liabilities</b>		
Accounts payable	\$ 4,843	\$ 4,773
Accrued expenses and other current liabilities	8,418	12,389
Current portion of lease liabilities	2,424	2,510
Current portion of unearned franchise and development fees	1,602	1,715
Current portion of long-term debt	8,400	11,400
Total current liabilities	25,687	32,787
Long-term debt, net of current portion	68,618	70,644
Lease liabilities, net of current portion	8,439	8,806
Unearned franchise and development fees, net of current portion	8,290	8,546
Deferred tax liability	23,477	23,121
Other long-term liabilities	3,450	3,797
Total liabilities	137,961	147,701
Commitments and contingencies (Note 14)		
<b>Stockholders' Equity</b>		
Preferred stock (\$0.01 par value; 15,000,000 shares authorized; no shares issued)	—	—
Common stock (\$0.01 par value; 200,000,000 shares authorized; 17,029,528 and 17,025,028 shares issued, respectively)	170	170
Additional paid-in capital	121,376	121,171
Accumulated deficit	(20,512)	(22,318)
Total stockholders' equity	101,034	99,023
Total liabilities and stockholders' equity	<u>\$ 238,995</u>	<u>\$ 246,724</u>

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Shareholders' Equity

<i>(In thousands)</i>	Three Months Ended April 1, 2019				
	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Equity
	Shares	Amount			
<b>BALANCE, December 31, 2018</b> . . . . .	17,025	\$ 170	\$ 121,171	\$ (22,318)	\$ 99,023
Exercise of stock options . . . . .	5	—	18	—	18
Stock based compensation expense . . .	—	—	187	—	187
Net income . . . . .	—	—	—	1,806	1,806
<b>BALANCE, April 1, 2019</b> . . . . .	<u>17,030</u>	<u>\$ 170</u>	<u>\$ 121,376</u>	<u>\$ (20,512)</u>	<u>\$ 101,034</u>

<i>(In thousands)</i>	Three Months Ended April 2, 2018				
	Common Stock		Additional Paid-In Capital	Accumulated Deficit	Total Equity
	Shares	Amount			
<b>BALANCE, January 1, 2018</b> . . . . .	16,971	\$ 170	\$ 120,614	\$ (26,642)	\$ 94,142
Stock based compensation expense . . .	—	—	185	—	185
Net income . . . . .	—	—	—	1,580	1,580
<b>BALANCE, April 2, 2018</b> . . . . .	<u>16,971</u>	<u>\$ 170</u>	<u>\$ 120,799</u>	<u>\$ (25,062)</u>	<u>\$ 95,907</u>

# Papa Murphy's Holdings, Inc. and Subsidiaries

## Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)	Three Months Ended	
	April 1, 2019	April 2, 2018
<b>Operating Activities</b>		
Net income . . . . .	\$ 1,806	\$ 1,580
Adjustments to reconcile to cash from operating activities		
Depreciation and amortization . . . . .	1,478	2,141
Loss on disposal or impairment of property and equipment . . . . .	21	2
Deferred taxes . . . . .	356	530
Stock-based compensation . . . . .	187	185
Other non-cash items . . . . .	80	79
Change in operating assets and liabilities		
Accounts receivable . . . . .	773	(1,023)
Prepaid expenses and other assets . . . . .	494	444
Unearned franchise and development fees . . . . .	(368)	(962)
Accounts payable . . . . .	205	(785)
Accrued expenses and other liabilities . . . . .	(5,084)	2,061
Net cash from operating activities . . . . .	(52)	4,252
<b>Investing Activities</b>		
Acquisition of property and equipment . . . . .	(307)	(80)
Acquisition of stores, less cash acquired . . . . .	(11)	—
Proceeds from sale of property and equipment . . . . .	52	73
Net cash from investing activities . . . . .	(266)	(7)
<b>Financing Activities</b>		
Payments on long-term debt . . . . .	(5,100)	(4,900)
Proceeds from exercise of stock options . . . . .	18	—
Net cash from financing activities . . . . .	(5,082)	(4,900)
Net change in cash and cash equivalents . . . . .	(5,400)	(655)
<b>Cash and Cash Equivalents, beginning of period . . . . .</b>	<b>5,766</b>	<b>2,174</b>
<b>Cash and Cash Equivalents, end of period . . . . .</b>	<b>\$ 366</b>	<b>\$ 1,519</b>
<b>Supplemental Disclosures of Cash Flow Information</b>		
Cash paid during the period for interest . . . . .	\$ 1,322	\$ 1,277
Cash (received) paid during the period for income taxes . . . . .	\$ (81)	\$ —

See accompanying notes.

# Papa Murphy's Holdings, Inc. and Subsidiaries

---

## Notes to Unaudited Condensed Consolidated Financial Statements

### Note 1 — Description of Business and Basis of Presentation

---

#### Description of Business

Papa Murphy's Holdings, Inc. ("Papa Murphy's" or the "Company"), together with its subsidiaries, is a franchisor and operator of a Take 'N' Bake pizza chain. The Company franchises the right to operate Papa Murphy's Take 'N' Bake pizza franchises and operates Papa Murphy's Take 'N' Bake pizza stores owned by the Company. As of April 1, 2019, the Company had 1,422 stores consisting of 1,384 domestic stores (1,278 franchised stores and 106 Company-owned stores) across 37 states, plus 38 franchised stores in Canada and the United Arab Emirates.

Substantially all of the Company's revenues are derived from retail sales of pizza and other food and beverage products to the general public by Company-owned stores and the collection of franchise royalties and fees associated with franchise and development rights.

#### Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the "SEC"). Accordingly, they do not include all information and footnotes required by generally accepted accounting principles in the United States ("GAAP") for complete financial statements. In the Company's opinion, all necessary adjustments, consisting of only normal recurring adjustments, have been made for the fair statement of the results of the interim periods presented. The results of operations for such interim periods are not necessarily indicative of the results to be expected for the full year. The accompanying interim unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements and the related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

#### Principles of Consolidation

The interim unaudited condensed consolidated financial statements include the accounts of Papa Murphy's Holdings, Inc., its subsidiaries and certain entities which the Company consolidates as variable interest entities. All significant intercompany transactions and balances have been eliminated.

Throughout the interim unaudited condensed consolidated financial statements and the related notes thereto, "Papa Murphy's" and "the Company" refer to Papa Murphy's Holdings, Inc. and its consolidated subsidiaries.

#### Fiscal Year

The Company uses a 52- or 53-week fiscal year, ending on the Monday nearest to December 31. Fiscal years 2019 and 2018 are 52-week years. All three month periods presented herein contain 13 weeks. All references to years and quarters relate to fiscal periods rather than calendar periods. References to fiscal 2019 and 2018 are references to fiscal years ending December 30, 2019 and ended December 31, 2018, respectively.

#### Recently Issued Accounting Standards

##### *Recent Accounting Pronouncements Not Yet Adopted*

In January 2017, the FASB issued ASU No. 2017-04, *Intangibles-Goodwill and Other: Simplifying the Test for Goodwill Impairment* ("ASU 2017-04"). The new standard simplifies how an entity measures goodwill impairment by removing the second step of the two-step quantitative goodwill impairment test. An entity will no longer perform a hypothetical purchase price allocation to measure goodwill impairment. Instead, impairment will be measured at the amount by which the carrying value exceeds the fair value of a reporting unit; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity still has the option to perform a qualitative assessment of whether it is more-likely-than-not that a reporting unit's fair value is less than its carrying amount. ASU 2017-04 requires prospective adoption and is effective for the annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019, with early adoption permitted. The Company is still evaluating the impact of ASU 2017-04 on its financial position and results of operations.

## Note 2 — Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following:

<i>(in thousands)</i>	April 1, 2019	December 31, 2018
Prepaid media production costs	\$ 605	\$ 724
Prepaid software and support	687	469
Prepaid occupancy related costs	135	136
Prepaid insurance	134	160
Taxes receivable	—	61
POS software licenses for resale	368	368
Assets held for sale	200	257
Advertising cooperative assets, restricted	46	(24)
Other	268	22
Total prepaid expenses and other current assets	<u>\$ 2,443</u>	<u>\$ 2,173</u>

## Note 3 — Property and Equipment

Property and equipment are net of accumulated depreciation of \$19.0 million and \$18.6 million at April 1, 2019, and December 31, 2018, respectively. Depreciation expense amounted to \$0.4 million and \$1.0 million during the three months ended April 1, 2019, and April 2, 2018, respectively.

## Note 4 — Intangible Assets

Definite-lived intangible assets are net of accumulated amortization of \$34.4 million and \$33.3 million as of April 1, 2019, and December 31, 2018, respectively. Amortization expense amounted to \$1.0 million and \$1.1 million during the three months ended April 1, 2019, and April 2, 2018, respectively.

## Note 5 — Financing Arrangements

Long-term debt consists of the following:

<i>(in thousands)</i>	April 1, 2019	December 31, 2018
Term loan	\$ 77,408	\$ 79,508
Notes payable	—	3,000
Total principal amount of long-term debt	77,408	82,508
Unamortized debt issuance costs	(390)	(464)
Total long-term debt	77,018	82,044
Less current portion	(8,400)	(11,400)
Total long-term debt, net of current portion	<u>\$ 68,618</u>	<u>\$ 70,644</u>

### Senior secured credit facility

On August 28, 2014, PMI Holdings, Inc., a wholly-owned subsidiary of Papa Murphy's Holdings, Inc., entered into a \$132.0 million senior secured credit facility (the "Senior Credit Facility") consisting of a \$112.0 million term loan and a \$20.0 million revolving credit facility, which includes a \$2.5 million letter of credit subfacility and a \$1.0 million swing-line loan subfacility.

On November 6, 2018, the Company extended the term of the Senior Credit Facility to August 2020 and reduced the revolving credit facility from \$20.0 million to \$7.5 million. The Company has shown as the current portion of long-term debt an amount equal to the minimum term loan amortization payments of \$2.1 million due on the last day of each fiscal quarter.

As of April 1, 2019, the term loan bears interest at a rate of 6.5% per annum based on the LIBOR rate option plus the applicable margin. The weighted average interest rate for all borrowings under the Senior Credit Facility for the first quarter of 2019 was 6.5%.

## Notes payable

Papa Murphy's Company Stores, Inc., a wholly owned subsidiary of Papa Murphy's Holdings, Inc., had a \$3.0 million note payable which bore interest at a rate of 5.0% per annum and matured in January 2019. This note was subordinated to the Senior Credit Facility and was paid in full in January 2019.

## Note 6 — Fair Value Measurement

The Company determines the fair value of assets and liabilities based on the price that would be received to sell the asset or paid to transfer the liability to a market participant. GAAP defines a fair value hierarchy that prioritizes the assumptions used to measure fair value. The three levels of the fair value hierarchy are defined as follows:

- Level 1 — Quoted prices in active markets for identical assets or liabilities that the entity has the ability to access.
- Level 2 — Observable inputs other than prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets and liabilities in markets that are not active; or other inputs that are observable or can be corroborated with observable market data.
- Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets and liabilities. This includes certain pricing models, discounted cash flow methodologies, and similar techniques that use significant unobservable inputs.

The following table presents information about the fair value of the Company's financial instruments:

<i>(in thousands)</i>	April 1, 2019		December 31, 2018		Fair Value Measurement
	Carrying Value	Fair Value	Carrying Value	Fair Value	
<b>Financial assets</b>					
Other receivables <sup>(1)</sup>	505	444	505	439	Level 3

(1) The fair value of other receivables was estimated primarily using a discounted cash flow method based on a discount rate, reflecting the applicable credit spread.

Financial instruments not included in the table above consist of cash and cash equivalents, accounts receivable, accounts payable, and long-term debt. The fair values of cash and cash equivalents, accounts receivable, and accounts payable approximate carrying value because of the short-term nature of the accounts. The fair value of long-term debt approximates carrying value because the borrowings are made with variable market rates and negotiated terms and conditions that are consistent with current market rates.

## Note 7 — Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consist of the following:

<i>(in thousands)</i>	April 1, 2019	December 31, 2018
Accrued compensation and related costs	\$ 2,382	\$ 4,100
Accrued legal settlement costs	—	2,363
Gift cards payable	2,206	2,700
Accrued interest and non-income taxes payable	328	318
Convention fund balance	1,428	1,175
Advertising cooperative liabilities	95	25
Income taxes payable	317	—
Lease liabilities held for sale	706	763
Other	956	945
Total accrued expenses and other current liabilities	\$ 8,418	\$ 12,389

## Note 8 — Revenue

### Revenue by Category

The following series of tables present revenue disaggregated by several categories for the periods reported.

Revenues by contract type were as follows:

<i>(in thousands)</i>	Three Months Ended April 1, 2019			
	Franchise	Company Stores	Brand Funds	Total
Franchise royalties	\$ 9,179	\$ —	\$ 3,687	\$ 12,866
Franchise fees	631	—	—	631
Vendor payments	—	—	1,208	1,208
E-commerce fees	713	—	—	713
Other franchise and brand	38	—	693	731
Company-owned stores	—	12,823	—	12,823
Total revenues	10,561	12,823	5,588	28,972
Intersegment revenues	698	—	365	1,063
Reconciliation to business segment revenues	\$ 11,259	\$ 12,823	\$ 5,953	\$ 30,035

<i>(in thousands)</i>	Three Months Ended April 2, 2018			
	Franchise	Company Stores	Brand Funds	Total
Franchise royalties	\$ 9,461	\$ —	\$ 3,840	\$ 13,301
Franchise fees	740	—	—	740
Vendor payments	—	—	1,117	1,117
E-commerce fees	546	—	—	546
Other franchise and brand	23	—	463	486
Company-owned stores	—	18,582	—	18,582
Total revenues	10,770	18,582	5,420	34,772
Intersegment revenues	992	—	465	1,457
Reconciliation to business segment revenues	\$ 11,762	\$ 18,582	\$ 5,885	\$ 36,229

Revenues by geographic location were as follows:

<i>(in thousands)</i>	Three Months Ended April 1, 2019			
	Franchise	Company Stores	Brand Funds	Total
United States	\$ 10,478	\$ 12,823	\$ 5,588	\$ 28,889
International	83	—	—	83
Total revenues	\$ 10,561	\$ 12,823	\$ 5,588	\$ 28,972

<i>(in thousands)</i>	Three Months Ended April 2, 2018			
	Franchise	Company Stores	Brand Funds	Total
United States	\$ 10,690	\$ 18,582	\$ 5,420	\$ 34,692
International	80	—	—	80
Total revenues	\$ 10,770	\$ 18,582	\$ 5,420	\$ 34,772

## Contract Balances

Changes in the balances of contract liabilities (unearned revenue) during the periods reported were as follows:

<i>(in thousands)</i>	<b>Contract Liabilities</b>
Balance at December 31, 2018 .....	\$ 9,878
Revenue recognized that was included in the balance at the beginning of the period .....	(619)
Cash received, net of amounts recognized as revenue during the period .....	260
Balance at April 1, 2019 .....	<u>\$ 9,519</u>

The Company had a refund liability of \$0.5 million as of each of April 1, 2019 and December 31, 2018. Receivables from contracts with customers included in Accounts receivable, net were \$2.7 million as of April 1, 2019 and \$3.1 million as of December 31, 2018, respectively.

The following table includes estimated franchise fee revenue expected to be recognized in the future related to performance obligations that were unsatisfied (or partially unsatisfied) as of April 1, 2019 (in thousands):

Fiscal year	2019 .....	\$ 1,214
	2020 .....	1,494
	2021 .....	1,339
	2022 .....	1,181
	2023 .....	951
	Thereafter .....	3,340
	Total .....	<u>\$ 9,519</u>

## Note 9 — Leases

The Company leases the property for its corporate headquarters, Company-owned stores, and certain office equipment. The Company is not a party to leases for franchise locations except for two locations that operate under a sublease and a few leases assigned to franchisees when stores were refranchised wherein it remains secondarily liable (see *Lease guarantees* below). The Company determines if an arrangement is a lease at inception. Operating leases are included in operating lease right of use assets, current portion of lease liabilities, and lease liabilities, net of current portion in the Condensed Consolidated Balance Sheets. The Company currently has no finance leases. The Company's leases have remaining lease terms of 1.2 to 12.8 years.

Lease expense for lease payments is recognized on a straight-line basis over the lease term. The components of lease expense for the periods reported are as follows:

<i>(in thousands)</i>	<b>Three Months Ended</b>	
	<b>April 1, 2019</b>	<b>April 2, 2018</b>
Operating lease cost .....	\$ 863	\$ 1,046
Short-term lease cost .....	12	14
Variable lease cost .....	3	1
Sublease income .....	(20)	(18)
Total lease cost .....	<u>\$ 858</u>	<u>\$ 1,043</u>

Supplemental cash flow information related to leases for the periods reported is as follows:

<i>(in thousands)</i>	<b>Three Months Ended</b>	
	<b>April 1, 2019</b>	<b>April 2, 2018</b>
<b>Cash paid for amounts included in the measurement of lease liabilities:</b>		
Operating cash flows from operating leases .....	\$ 1,155	\$ 1,222
Right of use assets obtained in exchange for new operating lease liabilities .....	448	—
Weighted-average remaining lease term of operating leases .....	5.1 years	5.7 years
Weighted-average discount rate of operating leases .....	6.1%	6.0%

Future minimum lease payments under non-cancelable leases as of April 1, 2019 are as follows (in thousands):

Fiscal year	2019	\$ 2,824
	2020	3,540
	2021	2,687
	2022	1,946
	2023	1,521
	Thereafter	2,601
	<b>Total future minimum lease payments</b>	<b>15,119</b>
	Less imputed interest	(2,313)
	Less lease liabilities held for sale <sup>(1)</sup>	(1,943)
	<b>Total Lease Liabilities</b>	<b>\$ 10,863</b>

(1) Lease liabilities held for sale includes \$0.7 million reported in Accrued expenses and other current liabilities (see Note 7 — *Accrued Expenses and Other Current Liabilities*) and \$1.2 million reported in Other long-term liabilities in the Company's Condensed Consolidated Balance Sheets.

As of April 1, 2019, the Company had no operating leases that had not yet commenced.

## Lease guarantees

The Company is the guarantor for operating leases of 40 franchised stores that have terms expiring on various dates from June 2019 to August 2025. The obligations from these leases will generally continue to decrease over time as the leases expire. The applicable franchise owners continue to have primary liability for these operating leases. As of April 1, 2019, the Company does not believe it probable that it would be required to perform under any of the remaining guarantees.

## Note 10 — Income Taxes

Information on the Company's income taxes for the periods reported is as follows:

<i>(in thousands)</i>	Three Months Ended	
	April 1, 2019	April 2, 2018
Provision for income taxes	\$ 654	\$ 581
Income before income taxes	2,460	2,161
Effective income tax rate	26.6%	26.9%

The effective income tax rates for the three months ended April 1, 2019 and April 2, 2018 include the effect of certain permanent differences between tax reporting purposes and financial reporting purposes and the effect of certain Federal General Business Credits confirmed during the quarter.

## Note 11 — Share-based Compensation

In May 2010, the Company's Board of Directors approved the 2010 Amended Management Incentive Plan (the "2010 Plan"). In May 2014, the Company's Board of Directors adopted the 2014 Equity Incentive Plan (the "2014 Plan," and together with the 2010 Plan, the "Incentive Plans"). The Incentive Plans reserve 2,116,747 common shares for equity incentive awards consisting of incentive stock options, non-qualified stock options, restricted stock awards, and unrestricted stock awards. Equity incentive awards may be issued from either the 2014 Plan or the 2010 Plan.

## Restricted common shares

Information with respect to restricted stock awards is as follows:

	Number of Shares of Restricted Common Stock			Weighted Average Award Date Fair Value Per Share
	Time Vesting	Market Condition	Performance Vesting	
Unvested, December 31, 2018	41,000	30,171	—	\$ 3.79
Granted	—	63,902	63,907	4.75
Unvested, April 1, 2019	41,000	94,073	63,907	\$ 4.41

## Stock options

Information with respect to stock option activity is as follows:

	Number of Shares Subject to Options		Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (thousands)
	Time Vesting	Market Condition			
Outstanding, December 31, 2018 . . . . .	803,344	111,290	\$ 7.23		
Granted . . . . .	384,818	—	4.75		
Exercised . . . . .	(4,500)	—	3.97		
Forfeited . . . . .	(200,399)	(4,336)	9.67		
Outstanding, April 1, 2019 . . . . .	983,263	106,954	\$ 5.91	8.6 years	\$ 371
Exercisable, April 1, 2019 . . . . .	241,362	—	\$ 8.20	6.9 years	\$ 79

## Compensation cost

Stock-based compensation expense recognized in connection with the Incentive Plans for each of the three months ended April 1, 2019 and April 2, 2018 amounted to \$0.2 million.

As of April 1, 2019, total unrecognized share-based compensation expense was \$2.0 million, with \$1.2 million associated with time vesting awards, \$0.5 million associated with market condition awards, and \$0.3 million associated with performance vesting awards. The remaining weighted average period for unrecognized share-based compensation expense was 2.1 years as of April 1, 2019.

## Note 12 — Brand Marketing Fund

The Company manages the Brand Marketing Fund (the “BMF”) on behalf of all Papa Murphy’s stores in the United States. The Company is committed under its franchise and other agreements to spend revenues of the BMF on marketing, creative efforts, media support, or related purposes specified in the agreements. Contributions to the BMF are recognized as revenue, while expenditures are included in selling, general, and administrative expenses. Expenditures of the BMF are primarily amounts paid to third parties, but may also include personnel expenses and allocated costs. At each reporting date, to the extent contributions to the BMF exceed expenditures on a cumulative basis, the excess contributions are recorded in accrued expenses in the Company’s Condensed Consolidated Balance Sheets. While no profit is recognized on amounts received by the BMF, when expenditures exceed contributions to the BMF on a cumulative basis, income from operations and net income may be affected due to the timing of when revenues are received and expenses are incurred.

Information on the Company’s BMF balances for the periods reported is as follows:

<i>(in thousands)</i>	Three Months Ended	
	April 1, 2019	April 2, 2018
Opening BMF deficit . . . . .	\$ (5,423)	\$ (5,461)
Net activity during the period . . . . .	109	(401)
Ending BMF deficit . . . . .	\$ (5,314)	\$ (5,862)

As of April 1, 2019, previously recognized expenses of \$5.3 million may be recovered in future periods if subsequent BMF contributions exceed expenditures.

## Note 13 — Earnings per Share (EPS)

The number of shares and earnings per share (“EPS”) data for all periods presented are based on the historical weighted-average shares of common stock outstanding. Basic EPS is calculated by dividing income available to common stockholders by the weighted-average number of shares of common stock outstanding during each period. Diluted EPS is calculated using income available to common stockholders divided by diluted weighted-average shares of common stock outstanding during each period, which includes unvested restricted common stock and outstanding stock options. Diluted EPS considers the impact of potentially dilutive securities except in periods in which there is a loss because the inclusion of the common shares underlying such securities would have an anti-dilutive effect.

The following table sets forth the computations of basic and diluted EPS:

	Three Months Ended	
	April 1, 2019	April 2, 2018
<i>(in thousands, except per share data)</i>		
<b>Earnings:</b>		
Net income	\$ 1,806	\$ 1,580
<b>Shares:</b>		
Weighted average common shares outstanding	16,956	16,906
Dilutive effect of restricted equity awards	37	39
Diluted weighted average number of shares outstanding	16,993	16,945
<b>Earnings per share:</b>		
Basic earnings per share	\$ 0.11	\$ 0.09
Diluted earnings per share	\$ 0.11	\$ 0.09

For the three months ended April 1, 2019, and April 2, 2018, an aggregated total of 0.4 million shares and 0.6 million shares, respectively, have been excluded from the diluted EPS calculation because their effect would have been anti-dilutive.

## Note 14 — Commitments and Contingencies

### Legal proceedings

The Company is from time to time involved in litigation, certain other claims and arbitration matters arising in the ordinary course of business. The Company accrues a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. Significant judgment is required in both the determination of the probability of a loss and the determination as to whether a loss is reasonably estimable. These accruals are reviewed at least quarterly and adjusted to reflect the effects of negotiations, settlements, rulings, advice of legal counsel and technical experts and other information and events pertaining to a particular matter. To the extent there is a reasonable possibility (within the meaning of Accounting Standards Codification (“ASC”) 450) that losses could exceed amounts already accrued, if any, and the additional loss or range of loss is able to be estimated, the Company discloses the additional loss or range of loss.

In some instances, the Company is unable to reasonably estimate any potential loss or range of loss. The nature and progression of litigation can make it difficult to predict the impact a particular lawsuit will have on its business. There are many reasons that the Company cannot make these assessments, including, among others, one or more of the following: the early stages of a proceeding; damages sought that are unspecified, unsupported, unexplained or uncertain; discovery not having been started or incomplete; the complexity of the facts that are in dispute; the difficulty of assessing novel claims; the parties not having engaged in any meaningful settlement discussions; the possibility that other parties may share in any ultimate liability; and/or the often slow pace of litigation.

The Company currently is subject to litigation with a group of its franchise owners. In January 2014, six franchise owner groups claimed that the Company misrepresented its sales volumes, made false representations to them and charged excess advertising fees, among other things. The Company engaged in mediation with these franchise owners, which is required under the terms of their franchise agreements, in order to address and resolve their claims, but was unable to reach a settlement agreement. On April 4, 2014, a total of twelve franchise owner groups, including those franchise owners that previously made the allegations described above, filed a lawsuit against the Company in the Superior Court in Clark County, Washington, making essentially the same allegations for violation of the Washington Franchise Investment Protection Act, fraud, negligent misrepresentation and breach of contract, and seeking declaratory and injunctive relief, as well as monetary damages. Based on motions filed by the Company in that lawsuit, the court ruled on July 9, 2014, that certain of the plaintiffs’ claims under the anti-fraud and nondisclosure provisions of the Washington Franchise Investment Protection Act should be dismissed and that certain other claims in the case would need to be more specifically alleged. The court also ruled that the six franchise owner groups who had not mediated with the Company prior to filing the lawsuit must mediate with the Company in good faith, and that their claims shall be stayed until they have done so.

On June 18, 2014, an additional 16 franchise owner groups, represented by the same counsel as the plaintiffs described above, filed a lawsuit in the Superior Court in Clark County, Washington making essentially the same allegations as made in the lawsuit described above and seeking declaratory and injunctive relief, as well as monetary damages. The court consolidated the two lawsuits into a single case and ordered that the plaintiffs in the new lawsuit, none of whom had mediated with the Company prior to filing the lawsuit, must do so, and that their claims be stayed until they have completed mediating with the Company in good faith.

In October 2014, the Company engaged in mediation with the 22 franchise owner groups who had not previously done so. As a result of that mediation and other efforts, the Company reached resolution with 13 of the franchise owner groups involved in the consolidated lawsuits, and their claims have either been dismissed or dismissal is pending.

In February 2015, the remaining franchise owner groups in the consolidated lawsuits filed an amended complaint, removing some claims, amending some claims, adding claims and naming some of the Company's former and current franchise sales staff as additional individual defendants. In September 2016, the remaining 15 franchise owner groups in the consolidated lawsuits filed an amended complaint to add a claim under the Washington Consumer Protection Act based on substantially the same allegations as the prior claims, to re-plead claims under the Washington Franchise Investment Protection Act that had previously been dismissed.

In June 2017, the parties moved for summary judgment. The Company moved for summary judgment against two of the remaining franchise owner groups, the board of directors members moved for summary judgment on all claims against them, and the plaintiffs moved for summary judgment against all defendants on their Washington Consumer Protection Act and Washington Franchise Investment Protection Act claims. A hearing on the summary judgment motions was held on October 13, 2017.

In July 2017, the Company engaged in mediation with the remaining 15 franchise owner groups in the consolidated lawsuits. As a result of that mediation and other efforts, the Company reached resolutions with six of the remaining franchise owner groups, and their claims have been dismissed.

In April 2018, the Company reached resolution with four of the remaining franchise owner groups, conditioned upon dismissal of their claims.

In June 2018, the Company reached resolution with an additional franchise owner group.

On June 29, 2018, the Court granted the Company's motion to strike the remaining franchise owner groups' jury demand. The Court denied the Company's motion for separate trials, because at the time of the hearing there were only two franchise owner groups remaining in the case, based on tentative settlements with two other groups.

In July 2018, the Company entered into final settlements with two of the aforementioned franchise owner groups.

In September 2018, the Company entered into a final settlement with an additional franchise owner group.

One franchise owner group remains in the case. Trial with the remaining franchise owner group has been postponed indefinitely due to pending discovery.

As before, the Company believes the allegations in this litigation lack merit and, for the remaining plaintiff, the Company will continue to vigorously defend its interests, including by asserting a number of affirmative defenses and, where appropriate, counterclaims. The Company provides no assurance that it will be successful in its defense of the remaining lawsuit; however, the Company does not currently expect the cost of resolving it to have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

The Company is named the defendant in a putative collective action filed by plaintiff Amanda Cottle on January 8, 2019, in the United States District Court for the Middle District of Florida. The lawsuit alleges that the Company violated the FLSA by failing to pay proper overtime wages to the plaintiff, a store manager. Ms. Cottle asks that the court certify the putative class and that unpaid wages and liquidated damages under the FLSA, as well as interest and fees, be awarded to her and each class member. The Company believes the allegations in this litigation lack merit and will vigorously defend its interests in the matter. The Company provides no assurance that it will be successful in its defense of this lawsuit; however, the Company does not currently expect the cost of resolving it to have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

In January 2019, the United States District Court for the Western District of Washington issued the final order and mandate releasing all claims relating to the putative class action lawsuit filed against us by plaintiff John Lennartson on May 7, 2015, alleging the Company failed to comply with the requirements of the Telephone Consumer Protection Act when it sent SMS text messages to consumers.

In addition to the foregoing, the Company is subject to routine legal proceedings, claims and litigation in the ordinary course of its business. The Company may also engage in future litigation with franchise owners to enforce the terms of franchise agreements and compliance with brand standards as determined necessary to protect the Company's brand, the consistency of products and the customer experience. Lawsuits require significant management attention and financial resources and the outcome of any litigation is inherently uncertain. The Company does not, however, currently expect that the costs to resolve these routine matters will have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

## Note 15 — Segment Information

The Company has the following reportable segments: (i) Franchise; (ii) Company Stores; and (iii) Brand Funds. The Franchise segment includes operations with respect to franchised stores and derives its revenues primarily from franchise and development fees and franchise royalties from franchised stores. The Company Stores segment includes operations with respect to Company-owned stores and derives its revenues from retail sales of pizza and side items to the general public. The Brand Funds segment includes the Brand Marketing Fund and the Company's Convention Fund.

The Company measures the performance of its segments based on segment adjusted EBITDA and allocates resources based primarily on this measure. "EBITDA" is calculated as net income before interest expense, income taxes, depreciation, and amortization. Segment adjusted EBITDA excludes certain unallocated and corporate expenses. Although segment adjusted EBITDA is not a measure of financial condition or performance determined in accordance with GAAP, the Company uses segment adjusted EBITDA to compare the operating performance of its segments on a consistent basis and to evaluate the performance and effectiveness of its operational strategies. The Company's calculation of segment adjusted EBITDA may not be comparable to that reported by other companies.

The following tables summarize information on revenues, adjusted EBITDA and assets for each of the Company's reportable segments and include a reconciliation of segment adjusted EBITDA to income before income taxes:

<i>(in thousands)</i>	Three Months Ended	
	April 1, 2019	April 2, 2018
<b>Revenues</b>		
Franchise segment . . . . .	\$ 11,259	\$ 11,762
Brand Funds segment . . . . .	5,953	5,885
Intersegment eliminations . . . . .	(1,063)	(1,457)
Franchise related . . . . .	16,149	16,190
Company Stores segment . . . . .	12,823	18,582
Total . . . . .	\$ 28,972	\$ 34,772

<i>(in thousands)</i>	Three Months Ended	
	April 1, 2019	April 2, 2018
<b>Segment Adjusted EBITDA</b>		
Franchise	\$ 6,083	\$ 7,287
Company Stores	(15)	1,074
Brand Funds	112	(238)
Total reportable segments adjusted EBITDA	6,180	8,123
Corporate and unallocated	(702)	(987)
Depreciation and amortization	(1,478)	(2,141)
Interest expense, net	(1,397)	(1,292)
CEO transition and restructuring costs <sup>(1)</sup>	204	(244)
E-commerce transition costs <sup>(2)</sup>	—	(358)
Strategic alternatives <sup>(3)</sup>	(188)	—
Litigation settlement and reserves <sup>(4)</sup>	(159)	(940)
<b>Income Before Income Taxes</b>	<b>\$ 2,460</b>	<b>\$ 2,161</b>

- (1) Represents non-recurring management transition and restructuring costs in connection with the recruitment of a new Chief Executive Officer and other executive positions.
- (2) Represents non-recurring costs incurred to complete the transition of our e-commerce platform to a third party developed and hosted solution.
- (3) Reflects costs associated with the exploration of strategic alternatives and negotiation of the definitive merger agreement.
- (4) Accruals made for litigation settlements and associated legal costs.

<i>(in thousands)</i>	April 1, 2019	December 31, 2018
	<b>Total Assets</b>	
Franchise	\$ 113,793	\$ 120,611
Company Stores	37,235	38,177
Brand Funds	835	873
Other <sup>(1)</sup>	87,132	87,063
Total	<b>\$ 238,995</b>	<b>\$ 246,724</b>

- (1) Other assets which are not allocated to the individual segments primarily include trade names and trademarks and taxes receivable.

## Note 16 — Subsequent Events

On April 10, 2019, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with MTY Franchising USA, Inc. (“Parent”) and MTY Columbia Merger Sub, Inc. (“Merger Sub”), a wholly owned subsidiary of Parent, providing for the acquisition of the Company by Parent in an all-cash transaction, consisting of a tender offer at a purchase price of \$6.45 per share in cash (the “Offer”) for all of the Company’s outstanding shares of common stock, par value \$0.01 per share (the “Common Stock”), followed by a subsequent merger of Merger Sub with and into the Company (the “Merger”), with the Company surviving the Merger as a wholly-owned subsidiary of Parent.

The foregoing description of the Merger Agreement does not purport to be complete and is subject to, and qualified in its entirety by, the full text of the Merger Agreement, a copy of which is attached as Exhibit 2.1 to the Company’s Current Report on Form 8-K dated April 11, 2019.

## Schedule 3

Pro forma condensed consolidated statement of income  
For the twelve-month period ended November 30, 2018  
(in thousands of dollars, except per share amounts)  
unaudited

	MTY	Pape Murphy's	Combined	Pro forma	Notes	Pro forma
	12 months ended	12 months		adjustments		consolidated
	November 30,	ended				
	2018	December 31,				
		2018				
Revenue	\$ 353,308	163,862	\$ 517,165	\$ (9,297)	4(a)	\$ 507,868
Expenses						
Operating expenses	225,560	137,361	362,921	1,060	4(b)(c)	363,981
Depreciation - property, plant and equipment	2,755	3,796	6,551	(1,619)	4(d)	4,932
Amortization - intangible assets	24,749	5,589	30,338	39	4(e)	30,377
Interest on long-term debt	11,717	6,755	18,472	2,988	4(f)(g)	21,460
Impairment charge on property, plant and equipment and intangible assets	5,531	-	5,531			5,531
	<u>270,312</u>	<u>153,501</u>	<u>423,813</u>	<u>2,468</u>		<u>426,281</u>
Other income (charges)						
Unrealized and realized foreign exchange gain	11	-	11	-		11
Interest income	649	-	649	-		649
Loss on revaluation of financial liabilities recorded at fair value through profit and loss	(1,461)	-	(1,461)	-		(1,461)
Other income	-	-	-	-		-
Gain (loss) on disposal property plant and equipment and intangible assets	710	(2,511)	(1,801)	-		(1,801)
Loss on early retirement of debt	-	(49)	(49)	-		(49)
Other expenses	-	(275)	-	-		-
	<u>(91)</u>	<u>(2,835)</u>	<u>(2,651)</u>	<u>-</u>		<u>(2,651)</u>
Income before taxes	<u>82,900</u>	<u>7,526</u>	<u>90,701</u>	<u>(11,765)</u>		<u>78,936</u>
Income taxes						
Current	18,721	242	18,963	(2,618)	4(h)	16,345
Deferred	(34,812)	1,680	(33,132)	-		(33,132)
	<u>(16,091)</u>	<u>1,922</u>	<u>(14,169)</u>	<u>(2,618)</u>		<u>(16,787)</u>
Net income from continuing operations	<u>98,991</u>	<u>5,604</u>	<u>104,870</u>	<u>(9,147)</u>		<u>95,723</u>
Profit from discontinued operations, net of tax			-	-		-
Net income	<u>\$ 98,991</u>	<u>\$ 5,604</u>	<u>\$ 104,870</u>	<u>\$ (9,147)</u>		<u>\$ 95,723</u>
Net income attributable to:						
Owners	\$ 98,580	\$ 5,604	\$ 104,184	\$ (9,147)		\$ 95,037
Non-controlling interests	411	-	411	-		411
	<u>\$ 98,991</u>	<u>\$ 5,604</u>	<u>\$ 104,595</u>	<u>\$ (9,147)</u>		<u>\$ 95,448</u>
Earnings per share (continuing operations)						
Basic	\$ 4.07					\$ 3.92
Diluted	\$ 4.06					\$ 3.92
Earnings per share						
Basic	\$ 4.07					\$ 3.92
Diluted	\$ 4.06					\$ 3.92
Weighted average number of shares outstanding						
Basic (in thousands)	24,228					24,228
Diluted (in thousands)	24,273					24,273

See the accompanying notes to the unaudited pro forma condensed consolidated financial statements.

**Pro forma condensed consolidated statement of income**  
For the three-month period ended February 28, 2019  
(in thousands of dollars, except per share amounts)  
unaudited

	MTY Three months ended February 28, 2019	Papa Murphy's 13 weeks ended April 1, 2019	Combined	Pro-forma adjustments	Notes	Pro-forma consolidated
Revenue	\$ 107,297	\$ 38,508	\$ 145,805	\$ (739)	4(a)	\$ 145,066
Expenses						
Operating expenses	78,921	31,330	110,251	(346)	4(b)(c)	109,905
Depreciation - property, plant and equipment	739	595	1,334	(238)	4(d)	1,096
Amortization - intangible assets	6,551	1,369	7,920	5	4(e)	7,925
Interest on long-term debt	3,142	1,857	4,999	577	4(f)(g)	5,576
Impairment charge on property, plant and equipment and intangible assets	-	-	-	-	-	-
	<u>89,353</u>	<u>35,151</u>	<u>124,504</u>	<u>(2)</u>		<u>124,502</u>
Other income (charges)						
Unrealized and realized foreign exchange gain	8	-	8	-		8
Interest income	165	-	165	-		165
Loss on revaluation of financial liabilities recorded at fair value through profit and loss	996	-	996	-		996
Gain (loss) on disposal property plant and equipment and intangible assets	73	(28)	45	-		45
Other expenses	-	(60)	(60)	-		(60)
	<u>1,242</u>	<u>(88)</u>	<u>1,154</u>	<u>-</u>		<u>1,154</u>
Income before taxes	<u>19,186</u>	<u>3,270</u>	<u>22,456</u>	<u>(737)</u>		<u>21,719</u>
Income taxes						
Current	5,287	396	5,683	(199)	4(h)	5,484
Deferred	(885)	473	(412)	-		(412)
	<u>4,402</u>	<u>869</u>	<u>5,271</u>	<u>(199)</u>		<u>5,072</u>
Net income from continuing operations	<u>14,784</u>	<u>2,400</u>	<u>17,184</u>	<u>(538)</u>		<u>16,647</u>
Profit from discontinued operations, net of tax	-	-	-	-		-
Net income	<u>\$ 14,784</u>	<u>\$ 2,400</u>	<u>\$ 17,184</u>	<u>\$ (538)</u>		<u>\$ 16,647</u>
Net income attributable to:						
Owners	\$ 14,748	\$ 2,400	\$ 17,148	\$ (538)		\$ 16,611
Non-controlling interests	36	-	36	-		36
	<u>\$ 14,784</u>	<u>\$ 2,400</u>	<u>\$ 17,184</u>	<u>\$ (538)</u>		<u>\$ 16,647</u>
Earnings per share (continuing operations)						
Basic	\$ 0.59					\$ 0.66
Diluted	\$ 0.58					\$ 0.66
Earnings per share						
Basic						\$ 0.66
Diluted						\$ 0.66
Weighted average number of shares outstanding						
Basic (in thousands)	25,170					25,170
Diluted (in thousands)	25,221					25,221

See the accompanying notes to the unaudited pro forma condensed consolidated financial statements.

**MTY Food Group Inc.**  
**Pro forma condensed combined financial information**  
**(in thousands of dollars except per share amounts)**  
**unaudited**

**Notes to the pro forma condensed combined financial information**

**1. Description of the transaction**

On May 23, 2019, the Company, through the merger of a wholly-owned subsidiary with Papa Murphy's Inc. ("PM"), acquired all the outstanding shares of PM. Under the terms of the transaction agreement, the consideration payable for the shares of IRG was approximately \$258 million financed by MTY existing credit facility.

**2. Basis of presentation**

The unaudited pro forma condensed combined statements of income for the twelve months ended November 30, 2018 and three months ended February 28, 2019 (the "pro forma statements") are derived from historical financial statements of MTY Food Group Inc. ("MTY") and of Papa Murphy's Inc. ("PM") and have been prepared in accordance with IFRS.

The accompanying unaudited pro forma condensed combined financial statements give effect to the transaction as if it had occurred as at December 1, 2017 and December 1, 2018 respectively for purposes of the unaudited pro forma condensed combined statements of income for the year ended November 30, 2018 and for the three-month period ended February 28, 2019.

The unaudited pro forma condensed combined statement of income for the year ended November 30, 2018 and for the three months ended February 28, 2019 were prepared using financial information for PM's most recent fiscal year and quarter, which ended on December 31, 2018 and April 1, 2019 respectively. Management believes the different period end dates do not represent a material departure from the business or operations of the combined entity, as the operations of PM have not changed materially over the covered time period.

Both the unaudited pro forma condensed combined statement of income for the twelve month period ended December 31, 2018 and the three-month period ended February 28, 2019 have been converted into Canadian currency at the average foreign exchange rate for the period mentioned above respectively.

The pro forma statements should be read in conjunction with the audited consolidated financial statements of MTY as of November 30, 2018 and with the unaudited condensed interim consolidated financial statements of MTY as of February 28, 2019. The pro forma statements are based on the same accounting policies and their methods of application as MTY's consolidated financial statements.

The pro forma adjustments are based on available financial information and certain estimates and assumption made by management.

The pro forma statements are not necessarily indicative of the results or financial position that would have been achieved if the transaction had actually occurred on the dates indicated or of the results and financial position of MTY that may be achieved in the future. No adjustments have been made to the pro forma statements to reflect operating cost savings or revenue synergies that may be obtained as a result of the transaction described herein or to normalize non-recurring revenues, expenses, gains or losses.

The purchase price and the purchase price allocation are based on the estimated fair market value of the assets acquired and liabilities assumed. These estimations have been made using information available to management as at the date of preparation of the pro forma statements. The valuation of the assets acquired and liabilities assumed will be finalized subsequent to the publication of this business acquisition report, and as a result, the purchase price allocation contained in this report will change.

In preparing the pro forma statements, a review was undertaken to identify differences between MTY's and PM's accounting policies and financial statement presentation. Certain historical balances have been reclassified to conform to the pro forma condensed combined presentation. Additional accounting policy and financial statement presentation differences may be identified after the filing of this business acquisition report.

### 3. Purchase price allocation

The acquisition of the shares of PM has been accounted for using the acquisition method. Management is currently carrying out a more specific analysis and changes will be made to the preliminary purchase price allocation. As a result, the actual amounts allocated to the identifiable assets acquired and liabilities assumed and the related operating results could vary materially in comparison to the amounts initially recorded.

The following summarizes the preliminary purchase price and preliminary purchase price allocation:

	<u>Preliminary Consideration</u>
	\$
Consideration paid:	
Cash and amount paid for early settlement of options	257,596
Less: cash acquired	<u>(2,435)</u>
Net consideration paid/cash outflow	<u>255,161</u>
	<u>Preliminary Purchase Price Allocation</u>
	\$
Net assets acquired:	
Current assets	
Cash	2,435
Accounts receivable	3,873
Inventory	1,195
Prepaid expenses and deposits	<u>1,992</u>
	9,495
Property, plant and equipment	5,031
Other intangible assets	1,277
Franchise rights	65,601
Trademark	115,203
Goodwill	<u>112,686</u>
	317,115
Current liabilities	
Accounts payable and accrued liabilities	17,017
Provisions	7,907
Gift card liability	<u>2,840</u>
	27,764
Other long-term liabilities	1,083
Deferred income taxes	<u>30,672</u>
	59,519
Net purchase price	<u>257,596</u>

#### 4. PRO FORMA ADJUSTMENTS IN CONNECTION WITH THE PM ACQUISITION

The following summarizes the pro forma adjustments in connection with the PM Acquisition to give effect to the acquisition as if it had occurred on December 1, 2017 for the unaudited pro forma consolidated statement of income for the year ended November 30, 2018 and as if it had occurred on December 1, 2018 the unaudited pro forma condensed consolidated statement of income for the three months ended February 28, 2019.

- (a) As part of the preliminary purchase price allocation, deferred revenues were recorded at their fair value. As part of the fair value assessment, it was determined that no revenue could be recognized on events prior to acquisition.
- (b) Removal of public filing fees incurred by PM prior to acquisition by MTY of \$385 and \$99 for the twelve and three-month periods ending November 30, 2018 and February 28, 2019 respectively.
- (c) To reflect the post combination expense related to the cancellation of PM's stock plan and the new long-term incentives plan put into effect. This had a net increase in expenses of \$1,445 for the twelve-month period ended November 30, 2018 and a net decrease in expenses of \$247 for the three-month period ended February 28, 2019.
- (d) Property, plant and equipment were recorded at their estimated fair value as part of the preliminary purchase price allocation. As a result of the fair value adjustment, the depreciation of property, plant and equipment was adjusted in the unaudited pro forma consolidated statement of income for the year ended November 30, 2018 and the unaudited pro forma condensed consolidated statement of income for the three months ended February 28, 2019.
- (e) As part of the acquisition, MTY acquired franchise agreements, trademarks and goodwill. The fair value of the net identifiable assets acquired replaces the carrying value of the same assets presented on the consolidated statement of financial position of PM.

The amortization of intangible assets is adjusted to reflect the difference between the fair value at the time of the transaction and the historical book value of those assets, as well as to reflect the difference in amortization policies. Franchise rights are typically amortized over the remaining term of the contract on acquisition plus one renewal term.

- (f) To record additional interest expense related to the \$255,382 drawn on MTY's existing credit facility. For the purpose of the unaudited pro forma statements of income, the Banker's acceptance rate is equal 1.98%. The additional drawing on the existing revolving credit facility will cause MTY to save 0.17% in standby fees.

<i>(thousands of dollars)</i>	<b>For the year ended November 30, 2018</b>	<b>For the three months ended February 28, 2019</b>
Interest expense	9,743	2,434

- (g) Interest charges of \$6,755 and \$1,857, which were incurred by PM on its credit facility existing prior to acquisition, were reversed in the unaudited condensed consolidated pro forma statements of income for the twelve months ended November 30, 2018 and for the three months- ended February 28, 2019 respectively. The line of credit of \$77,733 USD (\$104,232 CAD) was paid back as part of the closing conditions by the sellers.
- (h) To record tax effect on the pro forma adjustments, using a statutory rate of 27.1%. The effective tax rate of the consolidated corporation could be different than the statutory tax rate assumed for purposes of preparing the unaudited pro forma condensed consolidated financial statements as a result of a variety of factors, including post-acquisition activities.