Rosetta Resources Inc.
Form 10-Q
November 03, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934
For The Quarterly Period Ended September 30, 2014

OR

¨ Transition Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934
Commission File Number: 000-51801

ROSETTA RESOURCES INC.

(Exact name of registrant as specified in its charter)

Delaware	43-2083519
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
1111 Bagby Street, Suite 1600	
Houston, TX	77002
(Address of principal executive offices)	(Zip Code)

(713) 335-4000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Securities Exchange Act of 1934.

Large accelerated filer x	Accelerated filer ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes ¨ No x

The number of shares of the registrant's Common Stock, $0.001 par value per share, outstanding as of October 24, 2014 was 61,489,705 which excludes unvested restricted stock awards.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Rosetta Resources Inc.

Consolidated Balance Sheet

(In thousands, except par value and share amounts)

	September 30, 2014 (Unaudited)	December 31, 2013
Assets		
Current assets:		
Cash and cash equivalents	$23,627	$193,784
Accounts receivable	154,268	122,677
Derivative instruments	14,249	4,307
Prepaid expenses	9,050	9,860
Deferred income taxes	1,524	27,976
Other current assets	5,032	1,284
Total current assets	207,750	359,888
Oil and natural gas properties using the full cost method of accounting:		
Proved properties	5,172,365	3,951,397
Unproved/unevaluated properties, not subject to amortization	535,041	755,438
Gathering systems and compressor stations	278,045	168,730
Other fixed assets	29,794	26,362
	6,015,245	4,901,927
Accumulated depreciation, depletion and amortization, including impairment	(2,313,109)	(2,020,879)
Total property and equipment, net	3,702,136	2,881,048
Other assets:		
Debt issuance costs	26,756	25,602
Derivative instruments	8,347	5,458
Other long-term assets	281	4,622
Total other assets	35,384	35,682
Total assets	$3,945,270	$3,276,618
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$236,058	$190,950
Royalties and other payables	114,164	78,264
Derivative instruments	—	4,913
Total current liabilities	350,222	274,127
Long-term liabilities:		
Derivative instruments	966	433
Long-term debt	1,910,000	1,500,000
Deferred income taxes	179,833	136,407

Other long-term liabilities	19,705	17,317
Total liabilities	2,460,726	1,928,284
Commitments and Contingencies (Note 9)		
Stockholders' equity:		
Preferred stock, $0.001 par value; authorized 5,000,000 shares; no shares issued in 2014 or 2013	—	—
Common stock, $0.001 par value; authorized 150,000,000 shares; issued 62,272,702 shares and 62,032,162 shares at September 30, 2014 and December 31, 2013, respectively	62	61
Additional paid-in capital	1,193,492	1,182,672
Treasury stock, at cost; 785,185 shares and 724,755 shares at September 30, 2014 and December 31, 2013, respectively	(27,308)	(24,592)
Accumulated other comprehensive loss	(98)	(108)
Retained earnings	318,396	190,301
Total stockholders' equity	1,484,544	1,348,334
Total liabilities and stockholders' equity	$3,945,270	$3,276,618

See accompanying notes to the consolidated financial statements.

Rosetta Resources Inc.

Consolidated Statement of Operations

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Revenues:				
Oil sales	$168,016	$140,172	$462,396	$353,119
NGL sales	66,003	50,857	176,740	144,236
Natural gas sales	54,359	34,136	157,878	108,369
Derivative instruments	77,215	(30,597)	4,035	3,484
Total revenues	365,593	194,568	801,049	609,208
Operating costs and expenses:				
Lease operating expense	26,952	15,854	71,537	35,982
Treating and transportation	23,638	18,807	62,933	52,414
Taxes, other than income	13,191	7,896	35,656	24,286
Depreciation, depletion and amortization	128,255	60,915	293,670	153,382
Reserve for commercial disputes	5,800	—	5,800	—
General and administrative costs	23,438	18,790	64,643	52,830
Total operating costs and expenses	221,274	122,262	534,239	318,894
Operating income	144,319	72,306	266,810	290,314
Other expense (income):				
Interest expense, net of interest capitalized	21,011	6,907	53,628	26,009
Interest income	(1)	—	(14)	—
Other expense	(116)	620	12,531	1,061
Total other expense	20,894	7,527	66,145	27,070
Income before provision for income taxes	123,425	64,779	200,665	263,244
Income tax expense	45,017	23,754	72,570	93,387
Net income	$78,408	$41,025	$128,095	$169,857
Earnings per share:				
Basic	$1.28	$0.67	$2.08	$2.95
Diluted	$1.27	$0.67	$2.08	$2.93
Weighted average shares outstanding:				
Basic	61,484	61,152	61,439	57,656
Diluted	61,675	61,364	61,636	57,924

See accompanying notes to the consolidated financial statements.

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Rosetta Resources Inc.

Consolidated Statement of Comprehensive Income

(In thousands)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$78,408	$41,025	$128,095	$169,857
Other comprehensive income (loss):				
Amortization of accumulated other comprehensive gain (loss) related to de-designated hedges, net of income taxes of $58 and ($97) for the three and nine months ended September 30, 2013, respectively	—	(102)	—	171
Postretirement medical benefits prior service benefit (cost), net of income taxes of ($2) and ($3) for the three months ended September 30, 2014 and 2013, respectively, and ($6) and $98 for the nine months ended September 30, 2014 and 2013, respectively	4	6	10	(173)
Other comprehensive income (loss)	4	(96)	10	(2)
Comprehensive income	$78,412	$40,929	$128,105	$169,855

See accompanying notes to the consolidated financial statements.

Rosetta Resources Inc.

Consolidated Statement of Cash Flows

(In thousands)

(Unaudited)

	Nine Months Ended September 30, 2014	2013
Cash flows from operating activities:		
Net income	$128,095	$169,857
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, depletion and amortization	293,670	153,382
Deferred income taxes	69,914	89,358
Amortization of deferred loan fees recorded as interest expense	2,866	7,674
Loss on debt extinguishment	3,101	—
Stock-based compensation expense	9,821	8,293
(Gain) loss due to change in fair value of derivative instruments	(17,211)	3,280
Change in operating assets and liabilities:		
Accounts receivable	(31,592)	(11,230)
Prepaid expenses	2,053	(652)
Other current assets	(3,749)	171
Long-term assets	90	(105)
Accounts payable and accrued liabilities	17,848	32,347
Royalties and other payables	35,899	19,201
Other long-term liabilities	(14)	4,189
Excess tax benefit from share-based awards	—	(6,342)
Net cash provided by operating activities	510,791	469,423
Cash flows from investing activities:		
Acquisitions of oil and gas assets	(79,600)	(952,703)
Additions to oil and gas assets	(1,000,816)	(568,140)
Disposals of oil and gas assets	8	(1,402)
Net cash used in investing activities	(1,080,408)	(1,522,245)
Cash flows from financing activities:		
Borrowings on Credit Facility	795,000	580,000
Payments on Credit Facility	(685,000)	(515,000)
Issuance of Senior Notes	500,000	700,000
Retirement of Senior Notes	(200,000)	—
Proceeds from issuance of common stock	—	329,008
Deferred loan fees	(8,364)	(18,102)
Proceeds from stock options exercised	375	4,582
Purchases of treasury stock	(2,716)	(6,838)
Excess tax benefit from share-based awards	165	6,342
Net cash provided by financing activities	399,460	1,079,992
Net (decrease) increase in cash	(170,157)	27,170
Cash and cash equivalents, beginning of period	193,784	36,786
Cash and cash equivalents, end of period	$23,627	$63,956

Supplemental disclosures:		
Capital expenditures included in Accounts payable and accrued liabilities	$145,956	$126,780

See accompanying notes to the consolidated financial statements.

Rosetta Resources Inc.

Consolidated Statement of Stockholders’ Equity

(In thousands, except share amounts)

(Unaudited)

	Common Stock		Additional	Treasury Stock		Accumulated Other		Total Stockholders'
	Shares	Amount	Paid-In Capital	Shares	Amount	Comprehensive Loss	Retained Earnings	Equity
Balance at December 31, 2013	62,032,162	$ 61	$ 1,182,672	724,755	$ (24,592)	$ (108)	$ 190,301	$ 1,348,334
Excess tax benefit from share-based awards	—	—	165	—	—	—	—	165
Stock options exercised	19,000	1	375	—	—	—	—	376
Treasury stock - employee tax payment	—	—	—	60,430	(2,716)	—	—	(2,716)
Stock-based compensation	—	—	10,280	—	—	—	—	10,280
Vesting of restricted stock	221,540	—	—	—	—	—	—	—
Comprehensive income	—	—	—	—	—	10	128,095	128,105
Balance at September 30, 2014	62,272,702	$ 62	$ 1,193,492	785,185	$ (27,308)	$ (98)	$ 318,396	$ 1,484,544

See accompanying notes to the consolidated financial statements.

Rosetta Resources Inc.

Notes to Consolidated Financial Statements (unaudited)

(1) Organization and Operations of the Company

Nature of Operations. Rosetta Resources Inc. (together with its consolidated subsidiaries, the "Company") is an independent exploration and production company engaged in the acquisition and development of onshore energy resources in the United States of America. The Company's operations are located in the Eagle Ford shale in South Texas and the Permian Basin in West Texas.

These interim financial statements have not been audited. However, in the opinion of management, all adjustments, consisting of normal recurring adjustments necessary to fairly state the financial statements, have been included. Results of operations for interim periods are not necessarily indicative of the results of operations that may be expected for the entire year. In addition, these financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all disclosures required for financial statements prepared in conformity with accounting principles generally accepted in the U.S. ("GAAP"). These financial statements and notes should be read in conjunction with the Company's audited Consolidated Financial Statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 ("2013 Annual Report").

(2) Summary of Significant Accounting Policies

The Company has provided a discussion of significant accounting policies, estimates and judgments in its 2013 Annual Report. There have been no changes to the Company's significant accounting policies since December 31, 2013.

Recent Accounting Developments

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers. The ASU will supersede most of the existing revenue recognition requirements in GAAP and will require entities to recognize revenue at an amount that reflects the consideration to which the company expects to be entitled in exchange for transferring goods or services to a customer. The new standard also requires disclosures sufficient to enable users to understand an entity's nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. The pronouncement is effective for annual and interim reporting periods beginning after December 15, 2016, and is to be applied retrospectively, with early application not permitted. This guidance is not expected to have a material impact on the Company's consolidated financial position, results of operations, or cash flows.

(3) Property and Equipment

The Company's Total property and equipment, net consists of the following:

	September 30, 2014	December 31, 2013
	(In thousands)	
Proved properties	$5,172,365	$3,951,397
Unproved/unevaluated properties	535,041	755,438
Gathering systems and compressor stations	278,045	168,730
Other fixed assets	29,794	26,362
Total	6,015,245	4,901,927
Less: Accumulated depreciation, depletion and amortization	(2,313,109)	(2,020,879)
Total property and equipment, net	$3,702,136	$2,881,048

Acquisitions

2014 Permian Acquisition. On December 30, 2013, the Company entered into a definitive agreement with several private parties to acquire Delaware Basin assets covering 5,034 net acres located in Reeves County (the "2014 Permian Acquisition"). These assets include 13 gross producing wells, of which 11 are operated by the Company. The Company completed the 2014 Permian Acquisition on February 28, 2014, with an effective date of December 1, 2013, for total cash consideration of $83.8 million.

Gates Ranch Acquisition. In the second quarter of 2013, the Company acquired the remaining 10% working interest in certain producing wells along with a third party's option to participate in future wells in certain leases of its Gates Ranch leasehold located in the Eagle Ford shale (the "Gates Acquisition") in Webb County for total cash consideration of approximately $128.1 million. The transaction closed on June 5, 2013 (the "Gates Acquisition Date") and was financed with borrowings under the Company's senior secured revolving credit facility (the "Credit Facility"), as described in Note 7 – Debt and Credit Agreements. As of the Gates Acquisition Date, the Company owns a 100% working interest in the entire Gates Ranch leasehold.

2013 Permian Acquisition. On March 14, 2013, the Company entered into a purchase and sale agreement with Comstock Oil & Gas, LP to purchase producing and undeveloped oil and natural gas interests in the Permian Basin in Gaines and Reeves Counties, Texas (the "2013 Permian Acquisition"). The Company completed the 2013 Permian Acquisition on May 14, 2013, with an effective date of January 1, 2013, for total cash consideration of $825.2 million. The 2013 Permian Acquisition was financed with the proceeds from the Company's issuance of the 5.625% Senior Notes, as described in Note 7 – Debt and Credit Agreements, and the common stock offering described in Note 10 – Equity. In connection with the 2013 Permian Acquisition and related financings, the Company incurred total transaction costs of approximately $31.0 million, including (i) $5.6 million of commitment fees and related expenses associated with a bridge credit facility ("Bridge Credit Facility"), which were recorded as Interest expense since the Company did not borrow under the Bridge Credit Facility, (ii) $10.0 million of debt issuance costs paid in connection with the issuance of the 5.625% Senior Notes, which were deferred and are being amortized over the term of these senior notes, (iii) $13.1 million of equity issuance costs and related expenses associated with the common stock offering, which were reflected as a reduction of equity proceeds, and (iv) $2.3 million of consulting, investment, advisory, legal and other acquisition-related fees, which were expensed and are included in General and administrative costs.

The above transactions were accounted for under the acquisition method of accounting, whereby each respective purchase price was allocated to the assets acquired and liabilities assumed based on their estimated fair values, with any excess of the purchase price over the estimated fair value of the identifiable net assets acquired recorded as goodwill (or shortfall of purchase price versus net fair value recorded as bargain purchase). Based on the final purchase price allocations for these acquisitions, no goodwill or bargain purchase was recognized. The final purchase price allocations for these transactions, representing consideration paid, assets acquired and liabilities assumed as of the respective acquisition dates, are shown in the tables below.

2014 Permian Acquisition

	Final Total Purchase Price Allocation (In thousands)
Cash consideration	$ 83,752
Fair value of assets acquired:	
Oil and natural gas properties	
Proved properties	$ 61,520
Unproved/unevaluated properties	22,525
Total assets acquired	$ 84,045
Fair value of liabilities assumed:	
Asset retirement obligations	$ 293
Net assets acquired	$ 83,752

2013 Permian Acquisition and Gates Ranch Acquisition

	Final Total Purchase Price Allocation (In thousands)
Cash consideration	$ 953,242
Fair value of assets acquired:	
Other fixed assets	$ 600
Oil and natural gas properties	
Proved properties	290,273
Unproved/unevaluated properties	663,300
Total assets acquired	$ 954,173
Fair value of liabilities assumed:	
Asset retirement obligations	$ 931
Net assets acquired	$ 953,242

The fair value measurements of assets acquired and liabilities assumed are based on inputs that are not observable in the market and therefore represent Level 3 inputs. The fair values of oil and natural gas properties and asset retirement obligations were measured using valuation techniques that convert future cash flows to a single discounted amount. Significant inputs to the valuation of oil and natural gas properties included estimates of: (i) future production, including adjustments for risk; (ii) production rates; (iii) future operating and development costs; (iv) future commodity prices; (v) future cash flows; and (vi) a market-based weighted average cost of capital rate. These inputs required significant judgments and estimates by the Company's management at the time of the valuation and are the most sensitive and subject to change. See Note 5 – Fair Value Measurements for additional information.

The results of operations attributable to the 2014 Permian Acquisition were included in the Company's Consolidated Statement of Operations beginning on March 1, 2014 and increased Total revenues by $3.3 million and $9.2 million, respectively, and Operating income by $0.9 million and $3.2 million, respectively, for the three and nine months ended September 30, 2014.

The following unaudited pro forma information assumes the transactions and related financings for the 2013 Permian Acquisition and the Gates Acquisition occurred on January 1, 2012 and the 2014 Permian Acquisition occurred on January 1, 2013. The unaudited pro forma information includes the effects of issuing the 5.625% Senior Notes, the issuance of common stock in the equity offering and the use of proceeds from the debt and equity offerings as discussed above. The pro forma results of operations have been prepared by adjusting the Company's historical results to include the historical results of the acquired assets based on information provided by the sellers, the Company's knowledge of the acquired properties and the impact of the Company's purchase price allocation. The Company believes the assumptions used provide a reasonable basis for reflecting the pro forma significant effects directly attributable to the acquisitions and associated financings. The pro forma results of operations do not include any cost savings or other synergies that may result from the acquisitions, or any estimated costs that have been or will be incurred by the Company to integrate these assets. The pro forma information does not purport to represent what the Company's results of operations would have been if the 2013 Permian Acquisition and Gates Acquisition had occurred on January 1, 2012, and the 2014 Permian Acquisition had occurred on January 1, 2013.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014 (1)	2013 (2)	2014 (2)	2013
	(In thousands, except per share and share data)		(In thousands, except per share and share data)	
Total revenues	$365,593	$200,525	$804,146	$658,037
Net income	78,408	43,284	128,840	185,049
Earnings per share:				
Basic	$1.28	$0.71	$2.10	$3.03
Diluted	$1.27	$0.71	$2.09	$3.02
Weighted average shares outstanding:				
Basic	61,484	61,152	61,439	61,011
Diluted	61,675	61,364	61,636	61,279

(1) No pro forma adjustments were made for the period as all acquisitions and related financings are included in the Company's historical results.

(2)

No pro forma adjustments were made related to the 2013 Permian Acquisition and Gates Acquisition for the period as the acquisitions are included in the Company's historical results.

Additional Disclosures about Property and Equipment

The Company capitalizes internal costs directly identified with acquisition, exploration and development activities. The Company capitalized $1.9 million and $1.6 million of internal costs for the three months ended September 30, 2014 and 2013, respectively, and $5.6 million and $5.5 million for the nine months ended September 30, 2014 and 2013, respectively.

Oil and gas properties include unevaluated property costs of $535.0 million and $755.4 million as of September 30, 2014 and December 31, 2013, respectively, which are not being amortized. These amounts primarily represent acquisition costs of unproved properties and unevaluated exploration projects in which the Company owns a direct interest. Such costs are periodically evaluated for impairment, and upon evaluation or impairment are transferred to the Company's full cost pool and amortized. During the nine months ended September 30, 2014, the Company transferred $162.9 million of Permian acquisition costs to the full cost pool as a result of development activities in this area.

Pursuant to full cost accounting rules, the Company must perform a ceiling test each quarter on its proved oil and natural gas assets within each separate cost center. All of the Company's costs are included in one cost center because all of the Company's operations are located in the United States. The Company's ceiling test was calculated using trailing twelve-month, unweighted-

average first-day-of-the-month prices for oil and natural gas as of September 30, 2014, which were based on a West Texas Intermediate oil price of $95.56 per Bbl and a Henry Hub natural gas price of $4.24 per MMBtu (adjusted for basis and quality differentials), respectively. Utilizing these prices, the calculated ceiling amount exceeded the net capitalized cost of oil and natural gas properties as of September 30, 2014, and as a result, no write-down was recorded. It is possible that a write-down of the Company’s oil and gas properties could occur in future periods in the event that oil and natural gas prices significantly decline or the Company experiences significant downward adjustments to its estimated proved reserves.

(4) Commodity Derivative Contracts

The Company is exposed to various market risks, including volatility in oil, natural gas liquids (“NGL”) and natural gas prices, which are managed through derivative instruments. The level of derivative activity utilized depends on market conditions, operating strategies and available derivative prices. The Company utilizes various types of derivative instruments to manage commodity price risk, including fixed price swaps, basis swaps and costless collars. Forward contracts on various commodities are entered into to manage the price risk associated with forecasted sales of the Company’s oil, NGL and natural gas production.

As of September 30, 2014, the following derivative contracts were outstanding with associated notional volumes and average underlying prices that represent hedged prices of commodities at various market locations:

Product	Settlement Period	Derivative Instrument	Notional Daily Volume (Bbls)	Total Notional Volume (Bbls)	Average Floor/Fixed Prices per Bbl	Average Ceiling Prices per Bbl
Crude oil	2014	Costless Collar	3,000	276,000	$ 83.33	$109.63
Crude oil	2014	Swap	6,000	552,000	53,226	
Brand Funds	492		509			
Other(1)	87,131		87,201			
Total	$245,827		$262,115			

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

Note 18 — Subsequent Events

Senior secured credit facility

On November 6, 2018, PMI Holdings, Inc. entered into a second amendment to its Senior Credit Facility. The amendment, among other things, extends the term of the Senior 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.

Notes payable

On October 25, 2018, Papa Murphy's Company Stores, Inc. signed a second amendment to its note payable which extends the maturity date of the note to January 2019.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with the accompanying unaudited condensed consolidated financial statements and related notes in Item 1 and with the audited

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consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. To match our operating cycle, we use a 52- or 53-week fiscal year, ending on the Monday nearest to December 31. Our fiscal quarters each contain 13 operating weeks, with the exception of the fourth quarter of a 53-week fiscal year, which contains 14 operating weeks. Fiscal year 2018 is a 52-week period ending on December 31, 2018, and fiscal year 2017 was a 52-week period ended on January 1, 2018.

Cautionary Note Regarding Forward-Looking Statements

In addition to historical information, this discussion and analysis contains forward-looking statements that involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors including, but not limited to, those discussed in the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. All statements other than statements of historical fact or relating to present facts or current conditions included in this discussion and analysis are forward-looking statements. Forward-looking statements give our current expectations and projections relating to our financial condition, results of operations, plans, objectives, future performance and business. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. Examples of forward-looking statements include those regarding our future financial or operating results, cash flows, sufficiency of liquidity, financing resources, business strategies and priorities, shift in mix of marketing efforts, resolution of litigation and claims, expansion and growth opportunities, the mix of new store openings, our refranchising initiative, the reduction in the number of Company-owned stores, adoption of new accounting standards and the estimated effect of those new standards, our qualification as an “emerging growth company,” as well as industry trends and outlooks. These statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “plan,” “intend,” “believe,” “may,” “
“can have,” “likely” and other words and terms of similar meaning in connection with any discussion of the timing or nature of future operating or financial performance or other events.

The forward-looking statements contained in this discussion and analysis are based on assumptions that we have made in light of our industry experience and our perceptions of historical trends, current conditions, expected future developments and other factors we believe are appropriate in the circumstances. As you read and consider this discussion and analysis, you should understand that these statements are not guarantees of performance or results. They involve risks, uncertainties (many of which are beyond our control) and assumptions. Although we believe that these forward-looking statements are based on reasonable assumptions, you should be aware that many factors could affect our actual operating and financial performance and cause our performance to differ materially from the performance anticipated in the forward-looking statements. We believe these factors include, but are not limited to, those described under the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. Should one or more of these risks or uncertainties materialize, or should any of these assumptions prove incorrect, our actual operating and financial performance may vary in material respects from expectations based on these forward-looking statements.

Any forward-looking statement made by us in this discussion and analysis speaks only as of the date on which we make it. Factors or events that could cause our actual operating and financial performance to differ may emerge from time to time, and it is not possible for us to predict all of them. We undertake no obligation to publicly update any forward-looking statement, whether as a result of new information, future developments or otherwise, except as may be required by law.

2018 Highlights

Revenue

Total revenues for the three months ended October 1, 2018, compared to the three months ended October 2, 2017, declined 14.4% from $33.7 million to $28.8 million. Total revenues for the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, declined 14.2% from $110.0 million to $94.4 million. In both comparative periods, the declines in total revenues were due to (i) a decline in Company-owned store sales attributable to the refranchising of 29 and closure of six Company-owned stores since October 2, 2017, and (ii) a decline in royalties and advertising fees due to negative comparable store sales as noted below and a net decline of 47 franchise stores since October 2, 2017 (14 stores opened, 90 stores closed, and 29 stores refranchised).

Comparable store sales in 2018 compared to 2017 for selected segments were as follows:

	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Franchise	(1.8)%	(4.2)%	(2.7)%	(4.2)%
Company Stores	(6.9)%	(2.7)%	(4.5)%	(6.6)%
Total	(2.1)%	(4.1)%	(2.9)%	(4.5)%

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Comparable store sales for the three and nine months ended October 1, 2018 were lower compared to the same periods in the prior year primarily as a result of continued competitive headwinds and both convenience and relevance gaps.

Refranchising

In recent years, we had focused our financial resources on accelerating the build out of several markets with Company-owned stores. Consistent with our current strategy, we are now working to refranchise a significant number of our Company-owned stores to experienced and well-capitalized franchisees who can further grow these markets. During the nine months ended October 1, 2018, we refranchised 29 Company-owned stores, 20 in Colorado, seven in Texas, and two in Arkansas. Our target is to continue reducing the number of Company-owned stores to no more than 50 stores by 2020.

Store Development

During the three and nine months ended October 1, 2018, our franchise owners opened two and eight stores, respectively, and we did not open any Company-owned stores. While we operate some stores as Company-owned stores, we expect the majority of our new store expansion to continue to come from new franchised store openings.

E-commerce

On March 15, 2018, as previously announced, we completed our switchover to a third-party's e-commerce platform to accelerate progress on our convenience strategy. We have seen positive results to date as the average transaction amount continues to be about 20% higher for online orders than for in-store orders. We strategically use online-only promotions communicated through text and email messaging. The new platform enables online and mobile ordering to be fully integrated with third-party marketplace and delivery services, where available. As part of the transition, we incurred $350,000 in non-recurring conversion costs during the nine months ended October 2, 2017.

Accounting Standards

We adopted the new accounting standards for revenue recognition and leases effective January 2, 2018. These new standards had a material impact on our condensed consolidated financial statements. Beginning in fiscal year 2018, our financial results reflect adoption of the standards with prior periods restated accordingly. For the three and nine months ended October 2, 2017, the retrospective adoption of the revenue and lease standards decreased our net income by $809,000 and $499,000 and decreased our earnings per diluted share by $0.05 and $0.03, respectively. Refer to Recently Adopted Accounting Standards under Note 1 — Description of Business and Basis of Presentation (Part I, Item 1 of this Form 10-Q) for further discussion.

Key Operating Metrics

We evaluate the performance of our business using a variety of operating and performance metrics. Set forth below is a description of our key operating metrics.

	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Store average weekly sales	$9,660	$9,593	$10,225	$10,235
Comparable store sales	(2.1)%	(4.1)%	(2.9)%	(4.5)%
Comparable stores	1,442	1,483	1,442	1,483
System-wide sales (in thousands)	$184,163	$192,903	$594,062	$623,049
System-wide stores	1,460	1,542	1,460	1,542
Adjusted EBITDA (in thousands)	$4,666	$5,546	$16,382	$11,230

Average Weekly Sales

Average Weekly Sales ("AWS") consists of the average weekly sales of stores over a specified period of time. AWS is calculated by dividing the total net sales of our system-wide stores for the relevant time period by the number of weeks these stores were open in such time period. This measure allows management to assess changes in customer traffic and spending patterns in our stores.

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Comparable Store Sales

Comparable store sales represents the change in year-over-year sales for comparable stores. A comparable store is a store open for at least 52 full weeks from the comparable date (the Tuesday following the opening date). Comparable store sales reflects changes in the number of transactions and in customer spend per transaction at existing stores. Customer spend per transaction is affected by changes in menu prices, sales mix, and the number of items sold per customer.

System-Wide Sales

System-wide sales includes net sales by all of our system-wide stores. This measure allows management to assess the health of our brand, our relative position to competitors, and changes in our royalty revenues.

Store Openings, Closures, Acquisitions, and Divestitures

We review the number of new stores, the number of closed stores, and the number of acquired and divested stores to assess growth in system-wide sales, royalty revenues, and Company-owned store sales. We operate through a footprint of 1,460 stores as of October 1, 2018, of which 92.3% are franchised, located in 37 states plus Canada and the Middle East. The following table presents the changes in the number of stores in our system for the nine months ended October 1, 2018.

	Franchise				
	Domestic	International	Total Franchise	Company Stores	Total
Store count at January 1, 2018	1,338	40	1,378	145	1,523
Openings	7	1	8	—	8
Closings	(67)	(1)	(68)	(3)	(71)
Net transfers [1]	29	—	29	(29)	—
Store count at October 1, 2018	1,307	40	1,347	113	1,460

(1) Net transfers are the number of franchised stores acquired by us, less the number of Company-owned stores refranchised. During this period, the Company refranchised 29 Company-owned stores and did not acquire any franchised stores.

EBITDA and Adjusted EBITDA

To supplement our interim unaudited condensed consolidated financial statements presented in accordance with generally accepted accounting principles in the U.S. ("GAAP"), we consider certain financial measures that are not prepared in accordance with GAAP. These non-GAAP financial measures are not based on any standardized methodology prescribed by GAAP and are not necessarily comparable to similarly-titled measures presented by other companies.

Adjusted EBITDA is calculated as net (loss) income before interest expense, income taxes, depreciation, and amortization ("EBITDA") as adjusted for the effects of items that we do not consider indicative of our operating performance. Adjusted EBITDA is a supplemental measure of operating performance that does not represent and should not be considered as an alternative to net (loss) income, as determined by GAAP, and our calculation of Adjusted EBITDA may not be comparable to that reported by other companies.

Adjusted EBITDA is a non-GAAP financial measure. Management believes that this financial measure, when viewed with our results of operations in accordance with GAAP and our reconciliation of Adjusted EBITDA to net (loss) income, provides additional information to investors about certain material or unusual items that we do not expect to continue at the same level in the future. By providing this non-GAAP financial measure, we believe we are enhancing investors' understanding of our business and our results of operations, and assisting investors in evaluating how well we are executing strategic initiatives. We believe Adjusted EBITDA is used by investors as a supplemental measure to evaluate the overall operating performance of companies in our industry.

Management uses Adjusted EBITDA and other similar measures:

- in comparing our operating performance on a consistent basis;
- to calculate incentive compensation for our employees;
- for planning purposes, including the preparation of our internal annual operating budget; and
- to evaluate the performance and effectiveness of our operational strategies.

Adjusted EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of the limitations are:

- Adjusted EBITDA does not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our debt;

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although depreciation and amortization are non-cash charges, the assets being depreciated and amortized may have to be replaced in the future, and Adjusted EBITDA does not reflect the cash requirements for such replacements; and Adjusted EBITDA does not reflect our tax expense or the cash requirements to pay our taxes.

To address these limitations, we reconcile Adjusted EBITDA to the most directly comparable GAAP measure, net income. Further, we also review GAAP measures and evaluate individual measures that are not included in Adjusted EBITDA.

The following table provides a reconciliation of our net (loss) income to Adjusted EBITDA for the periods presented:

	Three Months Ended		Nine Months Ended	
(in thousands)	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Net (Loss) Income	$(639)	$(2,678)	$2,327	$(13,970)
Depreciation and amortization	1,662	2,336	5,677	8,359
(Benefit from) provision for income taxes	(159)	(2,051)	970	(7,678)
Interest expense, net	1,254	1,305	3,842	3,818
EBITDA	$2,118	$(1,088)	$12,816	$(9,471)
CEO transition and restructuring costs[1]	27	190	390	2,519
E-commerce impairment and transition costs[2]	—	—	350	9,124
Store divestitures, closures, and impairments[3]	2,521	5,981	1,797	8,595
Litigation settlement and reserves[4]	—	463	1,029	463
Adjusted EBITDA	$4,666	$5,546	$16,382	$11,230

(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 our 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 for litigation settlements.

Our Segments

As a result of changes in our executive management responsibilities, effective January 2, 2018 we changed our reportable segments by combining our domestic and international franchise business into a single Franchise segment and separating the Brand Funds business into a separate reportable segment. Management believes this change better reflects the priorities and decision-making analysis around the allocation of our resources. Prior period results for the affected segments have been retrospectively revised to reflect this change.

We operate in three business segments: Franchise, Company Stores, and Brand Funds. Our Franchise segment consists of our franchised stores, our Company Stores segment consists of our Company-owned stores, and our Brand Funds segment consists of our BMF and our Convention Fund.

Our Chief Operating Decision Maker ("CODM") uses segment adjusted EBITDA as the primary measure of segment performance to allocate resources. The CODM believes this measure provides an enhanced basis for consistently measuring segment performance against operational objectives and strategies. Segment adjusted EBITDA excludes certain unallocated and corporate expenses, which include costs related to our board of directors, CEO, CFO, and certain legal expenses. Although segment adjusted EBITDA is not a measure of financial condition or performance determined in accordance with GAAP, we use segment adjusted EBITDA to compare the operating performance of our segments on a consistent basis and to evaluate the performance and effectiveness of our operational strategies. Our calculation of segment adjusted EBITDA may not be comparable to that reported by other companies.

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The following tables set forth our revenues and segment adjusted EBITDA for each of our segments for the periods presented:

(in thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Revenues				
Franchise segment	$10,361	$9,610	$32,886	$31,432
Brand Funds segment	6,552	7,000	17,673	22,931
Intersegment eliminations	(1,041)	(439)	(3,683)	(1,402)
Franchise related	15,872	16,171	46,876	52,961
Company Stores segment	12,958	17,520	47,519	57,010
Total	$28,830	$33,691	$94,395	$109,971

(in thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Segment Adjusted EBITDA				
Franchise	$5,617	$4,778	$18,664	$19,208
Company Stores	(462)	312	529	1,637
Brand Funds	461	1,718	297	(3,814)
Total reportable segments adjusted EBITDA	5,616	6,808	19,490	17,031
Corporate and unallocated	(950)	(1,262)	(3,108)	(5,801)
Adjusted EBITDA	4,666	5,546	16,382	11,230
Depreciation and amortization	(1,662)	(2,336)	(5,677)	(8,359)
Interest expense, net	(1,254)	(1,305)	(3,842)	(3,818)
CEO transition and restructuring costs[1]	(27)	(190)	(390)	(2,519)
E-commerce impairment and transition costs[2]	—	—	(350)	(9,124)
Store divestitures, closures, and impairments[3]	(2,521)	(5,981)	(1,797)	(8,595)
Litigation settlement and reserves[4]	—	(463)	(1,029)	(463)
(Loss) Income Before Income Taxes	$(798)	$(4,729)	$3,297	$(21,648)

(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 our 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 for litigation settlements.

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Results of Operations

The following table sets forth our results of operations in dollars and as a percentage of total revenues for the three and nine months ended October 1, 2018, and October 2, 2017. Prior year numbers have been adjusted to reflect the impacts of adopting ASU 2014-09 (the new revenue accounting standard) and ASU 2016-02 (the new lease accounting standard). See Recently Adopted Accounting Standards under Note 1 — Description of Business and Basis of Presentation for more information on these two standards and a reconciliation of results as previously reported to adjusted results as presented below.

	Three Months Ended				Nine Months Ended			
	October 1, 2018		October 2, 2017		October 1, 2018		October 2, 2017	
(dollars in thousands)	$	Total % of Revenues	$ [(1)]	Total % of Revenues	$	Total % of Revenues	$ [(1)]	Total % of Revenues
Revenues								
Franchise related	$15,872	55.1 %	$16,171	48.0 %	$46,876	49.7 %	$52,961	48.2 %
Company-owned stores	12,958	44.9 %	17,520	52.0 %	47,519	50.3 %	57,010	51.8 %
Total revenues	28,830	100.0 %	33,691	100.0 %	94,395	100.0 %	109,971	100.0 %
Costs and Expenses								
Store operating costs:								
Cost of food and packaging [(2)]	4,216	14.6 %	5,858	17.3 %	15,657	16.5 %	19,376	17.7 %
Compensation and benefits [(2)]	4,341	15.1 %	5,478	16.3 %	15,183	16.1 %	17,735	16.1 %
Advertising [(2)]	1,147	4.0 %	1,604	4.8 %	3,700	3.9 %	5,055	4.6 %
Other store operating costs [(2)]	2,720	9.4 %	3,012	8.9 %	8,925	9.5 %	10,255	9.3 %
Selling, general, and administrative	11,710	40.6 %	12,517	37.2 %	36,146	38.4 %	49,042	44.6 %
Depreciation and amortization	1,662	5.8 %	2,336	6.9 %	5,677	6.0 %	8,359	7.6 %
Loss on disposal or impairment of property and equipment	2,521	8.7 %	6,253	18.6 %	1,808	1.9 %	17,830	16.2 %
Total costs and expenses	28,317	98.2 %	37,058	110.0 %	87,096	92.3 %	127,652	116.1 %
Operating Income (Loss)	513	1.8 %	(3,367)	(10.0)%	7,299	7.7 %	(17,681)	(16.1)%
Interest expense, net	1,254	4.4 %	1,305	3.8 %	3,842	4.0 %	3,818	3.5 %
Other expense, net	57	0.2 %	57	0.2 %	160	0.2 %	149	0.1 %
(Loss) Income Before Income Taxes	(798)	(2.8)%	(4,729)	(14.0)%	3,297	3.5 %	(21,648)	(19.7)%
(Benefit from) provision for income taxes	(159)	(0.6)%	(2,051)	(6.1)%	970	1.0 %	(7,678)	(7.0)%
Net (Loss) Income	$(639)	(2.2)%	$(2,678)	(7.9)%	$2,327	2.5 %	$(13,970)	(12.7)%

(1) Prior year numbers have been adjusted to reflect the impacts of adopting ASU 2014-09 (the new revenue accounting standard) and ASU 2016-02 (the new lease accounting standard). See Recently Adopted Accounting Standards under Note 1 — Description of Business and Basis of Presentation for more information on these two standards and a reconciliation of results as previously reported to adjusted results as presented above.

(2) Please see the table presented under Costs and Expenses below, which presents Company-owned store expenses as a percentage of Company-owned store sales for the three and nine months ended October 1, 2018, and October 2, 2017.

Revenues

Total revenues. In the three months ended October 1, 2018, total revenues decreased compared to the three months ended October 2, 2017, primarily due to (a) a decline in comparable store sales of 2.1%, (b) a decline in the number of Company-owned and franchise stores period-over-period; and (c) the elimination of an incremental advertising fee of 0.85% of sales charged to all franchise stores only in fiscal year 2017 to help fund the test of national advertising in the first quarter of 2017.

In the nine months ended October 1, 2018, total revenues decreased compared to the nine months ended October 2, 2017, primarily due to (a) a decline in comparable store sales of 2.9%, (b) a decline in the number of Company-owned and franchise stores period-over-period; and (c) the elimination of an incremental advertising fee of 0.85% of sales charged to all franchise stores only in fiscal year 2017 to help fund the test of national advertising in the first quarter of 2017.

Franchise revenues. Franchise revenues decreased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017, primarily due to (a) a decline in Franchise comparable store sales of 1.8%, (b) a net decline of 47 franchise stores period-over-period, and (c) the elimination of an incremental advertising fee of 0.85% of sales charged to all franchise stores only in fiscal year 2017 to help fund the test of national advertising in the first quarter of 2017.

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Franchise revenues decreased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, primarily due to (a) a decline in Franchise comparable store sales of 2.7%, (b) a net decline of 47 franchise stores period-over-period, and (c) the elimination of an incremental advertising fee of 0.85% of sales charged to all franchise stores only in fiscal year 2017 to help fund the test of national advertising in the first quarter of 2017.

Company-owned stores revenue. Company-owned stores revenue decreased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017, primarily due to a decline in comparable store sales of 6.9% and a reduction in the number of Company-owned stores period-over-period due to the refranchising of 29 and closure of six Company-owned stores since October 2, 2017.

Company-owned stores revenue decreased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, primarily due to a decline in comparable store sales of 4.5% in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, and a reduction in the number of Company-owned stores period-over-period due to the refranchising of 29 and closure of six Company-owned stores since October 2, 2017.

Costs and Expenses

Total costs and expenses. Total costs and expenses decreased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017, primarily as a result of impairments to our Company-owned store assets recorded in the three months ended October 2, 2017.

Total costs and expenses decreased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, primarily as a result of additional advertising costs incurred during the first quarter of 2017 associated with the national advertising test, impairments to our former e-commerce platform during the second quarter of 2017, and the aforementioned impairments to Company-owned store assets recorded in the three months ended October 2, 2017.

Store operating costs. Store operating costs as a percentage of total revenues increased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017 and decreased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017. The following table presents the components of store operating costs as a percentage of Company-owned store sales for the periods reported:

	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Store operating costs as a % of Company-owned store sales:				
Cost of food and packaging	32.5 %	33.4 %	32.9 %	34.0 %
Compensation and benefits	33.5 %	31.3 %	32.0 %	31.1 %
Advertising	8.9 %	9.2 %	7.8 %	8.9 %
Occupancy and other store operating costs	21.0 %	17.2 %	18.8 %	18.0 %
Total store operating costs	95.9 %	91.1 %	91.5 %	92.0 %

Total store operating costs as a percentage of Company-owned store sales increased by 480 basis points overall and decreased by 50 basis points overall, respectively, in the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017, due primarily to the effect of Company-owned store portfolio changes in select markets and as further explained below:

- Cost of food and packaging. Food and packaging costs declined during the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017 primarily due to decreases in commodity prices and the closing of six stores since October 2, 2017 that had lower sales and higher food costs as a percentage of store sales than the system average.
- Compensation and benefits. Compensation and benefits increased during the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017 primarily due to minimum wage increases in markets where we have Company-owned stores.

Advertising costs. Advertising costs decreased in the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017 primarily due to reduced levels of spending on advertising during the third quarter ended October 1, 2018.

Occupancy and other store operating costs. The increase in occupancy and other store operating costs as a percentage of Company-owned store sales during the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017 was primarily a result of gains on the settlement of lease liabilities recorded during the three months ended October 2, 2017, partially offset by increased repairs and maintenance expenditures during the three months ended October 1, 2018.

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Selling, general, and administrative. Selling, general, and administrative costs decreased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017, primarily as a result of reduced spending on compensation and benefits in the three months ended October 1, 2018 and legal settlement costs recorded in the three months ended October 2, 2017.

Selling, general, and administrative costs decreased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, primarily as a result of Brand Marketing Fund expenses incurred in 2017 associated with our first test of a national media campaign, and severance and restructuring costs incurred in 2017 associated with executive turnover and staff reductions.

Depreciation and amortization. Depreciation and amortization decreased in the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017, due to a reduction in our depreciable asset base as a result of a having fewer Company-owned stores period-over-period and the recording of impairment charges for our former e-commerce platform and Company-owned stores in four markets during 2017.

Interest expense, net. Interest expense, net decreased in the three months ended October 1, 2018, compared to the three months ended October 2, 2017, due to a reduction in the total amount of debt outstanding period-over-period, partially offset by increased average interest rates. Interest expense, net increased in the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, due to increased average interest rates, partially offset by a reduction in the total amount of debt outstanding period-over-period.

Income taxes. The (benefit from) provision for income taxes decreased in the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017, primarily due to the Federal corporate tax rate reduction made by the Tax Cuts and Jobs Act (the “2017 Tax Act”).

The effective tax rate for the three months ended October 1, 2018, was 19.9% compared to 43.4% for the three months ended October 2, 2017. The effective income tax rate decreased primarily due to the Federal corporate tax rate reduction made by the 2017 Tax Act.

The effective tax rate for the nine months ended October 1, 2018, was 29.4% compared to 35.5% for the nine months ended October 2, 2017. The effective income tax rate decreased primarily as a result of the Federal corporate tax rate reduction made by the 2017 Tax Act and from the negative impact of a discrete adjustment for share-based compensation expense recorded for vesting restricted common shares recorded earlier in the prior year. Our income taxes have varied from what would be expected from the application of prevailing statutory rates mainly due to the effect of meal and entertainment expenses and share-based compensation expenses.

Segment Results

Franchise. Total revenues for the Franchise segment increased $0.8 million and $1.5 million in the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017, respectively, primarily due to a change in intersegment revenues. Starting in fiscal year 2018, a royalty fee, comparable to what is charged to franchised stores, is charged to each Company-owned store. This royalty fee replaces the corporate overhead allocation that was in place through fiscal year 2017. This change increased Franchise intersegment revenues for the three and nine months ended October 1, 2018 by $0.6 million and $2.3 million, respectively, compared to the three and nine months ended October 2, 2017. This increase in Franchise revenues was partially offset by declines in Franchise royalty revenues of $0.3 million and $1.2 million for the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017, respectively, as a result of a decline in Franchise comparable store sales of 1.8% and 2.7%, respectively, and a reduction in the number of franchised stores period-over-period.

Adjusted EBITDA for the Franchise segment increased $0.8 million and decreased $0.5 million in the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017, respectively, primarily due to the aforementioned changes in the corporate overhead cost allocation methodology and declines in royalty revenues.

Company Stores. Total revenues for the Domestic Company Stores segment decreased $4.6 million and $9.5 million in the three and nine months ended October 1, 2018 compared to the three and nine months ended October 2, 2017, respectively, primarily due to declines in comparable store sales of 6.9% and 4.5%, respectively, and a reduction in the number of Company-owned stores period-over-period.

Adjusted EBITDA for the Domestic Company Stores segment decreased $0.8 million and $1.1 million in the three and nine months ended October 1, 2018, respectively, compared to the three and nine months ended October 2, 2017, primarily as a result of the aforementioned decline in revenues at Company-owned stores, the closure of six underperforming stores since October 2, 2017 and the aforementioned change to the corporate overhead cost allocation methodology.
Brand Funds. Total revenues for the Brand Funds segment decreased $0.4 million and $5.3 million for the three and nine months ended October 1, 2018, compared to the three and nine months ended October 2, 2017, respectively, primarily as a

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result of declines in comparable domestic store sales of 2.2% and 2.8%, respectively, and fewer domestic stores period-over-period. Additionally, for the nine month comparable periods, Brand Funds revenues declined due to the elimination of the incremental advertising fee of 0.85% of sales charged to domestic stores in fiscal year 2017 to partially fund the test of national advertising in the first quarter of 2017.

Adjusted EBITDA from the Brand Funds segment decreased $1.3 million for the three months ended October 1, 2018, compared to the three months ended October 2, 2017, primarily due to advertising spending patterns in 2017 that were heavily weighted toward the first quarter as a result of our test of national advertising and significantly lower during the third quarter of 2017.

Adjusted EBITDA from the Brand Funds segment increased $4.1 million for the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, primarily due to the elimination of advertising expenditures associated with our test of national advertising during the nine months ended October 2, 2017.

The table below shows the net impact of the BMF on the Brand Funds segment's adjusted EBITDA and the current fund deficit. The Convention Fund had EBITDA of zero for the three and nine months ended October 1, 2018 and October 2, 2017, respectively, and a fund surplus of $0.8 million and $1.1 million as of October 1, 2018 and October 2, 2017, respectively.

(in thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2018	October 2, 2017	October 1, 2018	October 2, 2017
Opening BMF deficit	$(5,877)	$(6,604)	$(5,461)	$(1,071)
Net activity during the period	461	1,718	45	(3,815)
Ending BMF deficit	$(5,416)	$(4,886)	$(5,416)	$(4,886)

Liquidity and Capital Resources

Our primary sources of liquidity are cash flows from operating activities and proceeds from the incurrence of debt, which together are sufficient to fund our operations, tax payments, capital expenditures, interest, fees, and principal payments on our debt as well as support our growth strategy. If the need arises, we may seek additional funding. Our ability to obtain additional financing will depend on many factors, including prevailing market conditions, our financial condition, and our ability to negotiate favorable terms and conditions. Financing may not be available on terms that are acceptable or favorable to us, if at all.

As of October 1, 2018, we had Cash and cash equivalents of $3.4 million and $20.0 million of available borrowings under a revolving line of credit, of which none was drawn. As of October 1, 2018, we had $84.8 million of outstanding indebtedness. Principal payments under our Senior Credit Facility are due on the last day of each fiscal quarter through the life of the Senior Credit Facility. On November 6, 2018, we entered into a second amendment to our Senior Credit Facility that, among other things, extended the term of the Senior Credit Facility by twelve months to August 2020 and reduced the revolving line of credit from $20.0 million to $7.5 million. We believe that our cash flows from operations, available cash and cash equivalents, and available borrowings under our revolving credit facility will be sufficient to meet our liquidity needs for at least the next 12 months.

As of October 1, 2018, we were in compliance with all of our covenants and other obligations under our Senior Credit Facility.

For more information on the second amendment to our Senior Credit Facility, see Part II, Item 5 of this Quarterly Report on Form 10-Q.

Cash Flows

The following table presents a summary of cash flows from operating, investing, and financing activities for the periods presented:

(in thousands)	Nine Months Ended	
	October 1, 2018	October 2, 2017
Cash flows from operating activities	$5,019	$8,224

Cash flows from investing activities	7,186	(709)
Cash flows from financing activities	(11,020)	(8,685)
Total cash flows	$ 1,185	$ (1,170)

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Cash Flows from Operating Activities

Net cash provided by operating activities of $5.0 million for the nine months ended October 1, 2018, resulted primarily from net income of $2.3 million, adjusted for items such as depreciation and amortization, gains and losses on the disposal or impairment of property and equipment, and changes in operating assets and liabilities. The $3.2 million decrease for the nine months ended October 1, 2018, compared to the nine months ended October 2, 2017, was primarily driven by reduced spending on marketing during the first quarter of 2018 compared to the first quarter of 2017, which included our test of national advertising. This reduction in advertising spend was partially offset by lower advertising fee revenues due to the elimination of an incremental advertising fee of 0.85% of sales charged to all franchise stores only in fiscal year 2017 to help fund the test of national advertising in the first quarter of 2017.

Cash Flows from Investing Activities

Net cash provided by investing activities was $7.2 million for the nine months ended October 1, 2018, compared to net cash used of $0.7 million for the nine months ended October 2, 2017. The $7.9 million increase in cash provided by investing activities was due primarily to $8.1 million in proceeds from the sale and refranchising of 29 stores in the nine months ended October 1, 2018 compared to proceeds of $2.2 million from the sale and refranchising of seven stores for the nine months ended October 2, 2017, and a period-over-period decrease of $2.5 million in capital expenditures for property, plant, and equipment.

Cash Flows from Financing Activities

Net cash used by financing activities was $11.0 million for the nine months ended October 1, 2018, compared to net cash used of $8.7 million for the nine months ended October 2, 2017. The $2.3 million increase in net cash used by financing activities was primarily due to extra payments on our long-term debt and no net borrowings under our revolving credit facility during the nine months ended October 1, 2018.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses. On an ongoing basis, we evaluate our judgments and estimates, including those related to revenue recognition, impairment of goodwill and intangible assets, income taxes, advertising expense, leases, and share-based compensation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable in the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

The accounting policies we believe to be most critical to understanding our financial results and condition and that require complex and subjective management judgments and estimates are identified and described in our annual consolidated financial statements and the notes included in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. For a discussion of new accounting standards that have been issued by the FASB and have been adopted during the current year, see Note 1 — Description of Business and Basis of Presentation to the interim unaudited condensed consolidated financial statements in Part I, Item 1.

JOBS Act

We qualify as an “emerging growth company” pursuant to the provisions of the Jumpstart Our Business Startup Act of 2012 (the “JOBS Act”). For as long as we are an “emerging growth company,” we may take advantage of certain exemptions from various reporting requirements that are applicable to other public companies that are not “emerging growth companies,” including, but not limited to, not being required to comply with the auditor attestation requirements of Section 404(b) of the Sarbanes-Oxley Act, reduced disclosure obligations regarding executive compensation in our periodic reports and proxy statements, reduced disclosure obligations relating to the presentation of financial statements in Management’s Discussion and Analysis of Financial Condition and Results of Operations, exemptions from the requirements of holding advisory “say-on-pay” votes on executive compensation and shareholder advisory votes on golden parachute compensation. We have availed ourselves of these reduced reporting and disclosure requirements in our existing filings and expect to continue to avail ourselves of the reduced reporting and disclosure requirements available to emerging growth companies in future filings. We could be an “emerging growth company” until the end of our 2019 fiscal year.

In addition, an emerging growth company can delay its adoption of certain accounting standards until those standards would otherwise apply to private companies. However, we chose to “opt out” of this extended transition period, and as a result, we will comply with any new or revised accounting standards on the relevant dates on which non-emerging growth companies must adopt the standards. Section 107 of the JOBS Act provides that our decision to opt out of the extended transition period for complying with new or revised accounting standards is irrevocable.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

As a "smaller reporting company", we are not required to provide the information required by this Item.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, pursuant to Rule 13a-15 under the Securities Exchange Act of 1934 (the “Exchange Act”). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures are effective to provide reasonable assurance that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) of the Exchange Act) that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II — OTHER INFORMATION

Item 1. Legal Proceedings

Except as set forth below, there have been no material developments in the legal proceedings described in Part I, Item 3, of our Annual Report on Form 10-K for the fiscal year ended January 1, 2018.

Franchise Owner Litigation

The Company currently is subject to litigation with a group of its franchise owners described in more detail in Part I, Item 3, of our Annual Report on Form 10-K for the fiscal year ended January 1, 2018 and in Note 16 — Commitments and Contingencies to the financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

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 Superior Court in Clark County, Washington 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.

There is one franchise owner group remaining in the case, with a trial scheduled to start in the spring of 2019 in the Superior Court in Clark County, Washington.

TCPA Litigation

The Company currently is named as a defendant in a putative class action lawsuit alleging the Company failed to comply with the requirements of the Telephone Consumer Protection Act ("TCPA") when it sent SMS text messages to consumers. This litigation is described in more detail in Part I, Item 3, of our Annual Report on Form 10-K for the fiscal year ended January 1, 2018 and in Note 16 — Commitments and Contingencies to the financial statements included in Item 1 of this Quarterly Report on Form 10-Q.

On April 23, 2018, the parties entered into a Settlement Agreement and Release and plaintiffs filed a Motion and Memorandum for Preliminary Approval of Settlement with the United States District Court for the Western District of Washington. The Court gave preliminary approval to the settlement on May 16, 2018, in its Preliminary Approval Order Approving Settlement, Certifying Settlement Class, Approving Notice Plan, and Setting Fairness Hearing. The Court gave final approval to the settlement on September 28, 2018, in its Amended Final Order Approving Class Action Settlement, which resulted in the settlement and release of all claims, subject to appeal.

Item 1A. Risk Factors

An investment in our common stock involves a high degree of risk. A detailed discussion of our risk factors is included under the section title "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. There have been no material changes from the risk factors previously disclosed in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018. If any of these risks, as well as other risks and uncertainties that are not yet identified or that we currently think are immaterial, actually occur, our business, results of operations or financial condition could be materially and adversely affected. In such an event, the trading price of our common stock could decline and you could lose part or all of your investment. The risk factors and other information included in our Annual Report on Form 10-K for the fiscal year ended January 1, 2018, should be carefully considered before making an investment decision relating to our common stock.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases of Common Stock

During the three months ended October 1, 2018, the Company repurchased the following shares of common stock:

	Total Number of Shares Purchased		Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 3 to July 31, 2018	—		$ —	—	N/A
August 1 to August 31, 2018	—		—	—	N/A
September 1 to October 1, 2018	754	(1)	0.19	—	N/A
Total	754		$ 0.19	—	N/A

(1) The Company repurchased unvested restricted shares from a former employee whose employment with the Company had terminated. The unvested shares were repurchased by the Company at the historical price paid by the former employee for the unvested shares.

Item 5. Other Information

On November 6, 2018, PMI Holdings, Inc. (“PMI”), a wholly-owned subsidiary of the Company, entered into a Second Amendment to Credit Agreement (the “Second Amendment”), by and among PMI, the guarantors party thereto, the lenders party thereto and Wells Fargo Bank, National Association, as administrative agent on behalf of the other lenders under the Credit Agreement (as successor to Antares Capital LP (as successor to General Electric Capital Corporation), the “Administrative Agent”). The Second Amendment amends certain terms of our Credit Agreement that provides for our Senior Credit Facility, dated August 28, 2014, by and among PMI, as the borrower, the guarantors party thereto, the lenders party thereto and the Administrative Agent, as amended.

The Second Amendment provides for, among other things, (a) the extension of the maturity date from August 28, 2019 to August 28, 2020, (b) the continuation of scheduled quarterly principal payments on the outstanding term loan of $2,100,000 per quarter, (c) the reduction in the revolving line of credit under the Senior Credit Facility from $20,000,000 to $7,500,000, (d) an increase in our maximum consolidated leverage ratio of 0.25x for the quarters ending April 1, 2019 and July 1, 2019, and (e) an increase in the applicable margin applicable to borrowings under the Senior Credit Facility of (i) 50 basis points if our maximum consolidated leverage ratio is equal to or less than 4.0x during the applicable measurement period and (ii) 75 basis points if our maximum consolidated leverage ratio is greater than 4.0x during the applicable measurement period.

As a condition to the effectiveness of the Second Amendment, we paid a customary amendment fee to the lenders consenting to the Second Amendment.

The above description of the material terms and conditions of the Second Amendment does not purport to be complete and is qualified in its entirety by reference to the full text of the Second Amendment, a copy of which is filed as Exhibit 10.1 to this Quarterly Report on Form 10-Q.

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Item 6. Exhibits.

Exhibit Number	Description of Exhibits	Form	File Number	Exhibit	Filing Date
10.1*	Second Amendment to Credit Agreement, dated as of November 6, 2018, among PMI Holdings, Inc., Wells Fargo Bank, National Association, and the other financial institutions party thereto.				
31.1*	Certification of the Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.				
31.2*	Certification of the Chief Financial Officer Pursuant to Rule 13a-14(a) or 15d-14(a) of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.				
32.1*	Certificate of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				
32.2*	Certificate of the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.				
101.INS*	XBRL Instance Document				
101.SCH*	XBRL Taxonomy Extension Schema Document				
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase Document				
101.DEF*	XBRL Taxonomy Extension Definition Linkbase Document				
101.LAB*	XBRL Taxonomy Extension Label Linkbase Document				
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase Document				

* Filed herewith

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SIGNATURES

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

PAPA MURPHY’S HOLDINGS, INC.

By: /s/ Nik Rupp
Name: Nik Rupp
Title: Chief Financial Officer

Date: November 7, 2018