

Papa Murphy's Holdings, Inc.  
Form 10-Q  
August 10, 2015  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

---

FORM 10-Q

---

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.

For the quarterly period ended June 29, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to  
Commission file number 001-36432

---

Papa Murphy's Holdings, Inc.  
(Exact name of registrant as specified in its charter)

---

Delaware  
(State or Other Jurisdiction of  
Incorporation or Organization)  
8000 NE Parkway Drive, Suite 350  
Vancouver, WA  
(Address of principal executive offices)  
(360) 260-7272  
(Registrant's telephone number, including area code)

27-2349094  
(IRS Employer  
Identification No.)  
98662  
(Zip 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 . No . Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes . No .

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

At July 31, 2015, there were 16,922,867 shares of the Registrant's common stock, \$0.01 par value, outstanding.



Table of Contents

TABLE OF CONTENTS

PART I — FINANCIAL INFORMATION

Item 1.	Unaudited Condensed Consolidated Financial Statements	<u>3</u>
	Unaudited Condensed Consolidated Statements of Operations for the three and six months ended June 29, 2015, and June 30, 2014	<u>3</u>
	Unaudited Condensed Consolidated Balance Sheets as of June 29, 2015, and December 29, 2014	<u>4</u>
	Unaudited Condensed Consolidated Statements of Cash Flows for the six months ended June 29, 2015, and June 30, 2014	<u>5</u>
	Notes to Unaudited Condensed Consolidated Financial Statements	<u>6</u>
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>21</u>
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	<u>36</u>
Item 4.	Controls and Procedures	<u>36</u>

PART II — OTHER INFORMATION

Item 1.	Legal Proceedings	<u>38</u>
Item 1A.	Risk Factors	<u>39</u>
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	<u>59</u>
Item 3.	Defaults Upon Senior Securities	<u>59</u>
Item 4.	Mine Safety Disclosures	<u>59</u>
Item 5.	Other Information	<u>59</u>
Item 6.	Exhibits	<u>60</u>

SIGNATURES		<u>61</u>
------------	--	-----------

Table of Contents

## PART I — FINANCIAL INFORMATION

## Item 1. Financial Statements

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

## Unaudited Condensed Consolidated Statements of Operations

(In thousands, except share and per share data)	Three Months Ended		Six Months Ended		
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014	
Revenues					
Franchise royalties	\$9,753	\$9,315	\$20,433	\$19,384	
Franchise and development fees	830	862	1,970	2,031	
Company-owned store sales	18,156	11,477	35,323	23,495	
Lease and other	382	192	564	2,053	
Total revenues	29,121	21,846	58,290	46,963	
Costs and Expenses					
Store operating costs:					
Cost of food and packaging	6,443	4,499	12,533	9,089	
Compensation and benefits	4,722	2,905	9,076	5,935	
Advertising	1,753	1,122	3,422	2,244	
Occupancy	1,174	674	2,176	1,334	
Other store operating costs	1,856	1,007	3,301	2,076	
Selling, general and administrative	8,162	8,824	15,045	17,023	
Depreciation and amortization	2,420	1,967	4,739	3,808	
Loss on disposal of property and equipment	3	36	62	42	
Total costs and expenses	26,533	21,034	50,354	41,551	
Operating Income	2,588	812	7,936	5,412	
Interest expense	1,149	2,316	2,292	5,428	
Interest income	(6	) (19	) (19	) (53	)
Loss on early retirement of debt	—	1,191	—	1,191	
Loss on disposal or impairment of investments	4,500	—	4,500	—	
Other expense, net	44	43	46	55	
(Loss) Income Before Income Taxes	(3,099	) (2,719	) 1,117	(1,209	)
(Benefit from) provision for income taxes	(1,160	) (1,112	) 460	(421	)
Net (Loss) Income	(1,939	) (1,607	) 657	(788	)
Net loss attributable to noncontrolling interests	500	—	500	—	
Net (Loss) Income Attributable to Papa Murphy's	\$(1,439	) \$(1,607	) \$1,157	\$(788	)
(Loss) earnings per share of common stock					
Basic	\$(0.09	) \$(0.19	) \$0.07	\$(0.39	)
Diluted	\$(0.09	) \$(0.19	) \$0.07	\$(0.39	)
Weighted average common stock outstanding					
Basic	16,629,666	11,375,211	16,616,936	7,612,646	
Diluted	16,629,666	11,375,211	16,872,504	7,612,646	
See accompanying notes.					



Table of ContentsPapa Murphy's Holdings, Inc. and Subsidiaries  
Unaudited Condensed Consolidated Balance Sheets

(In thousands, except par value and share data)	June 29, 2015	December 29, 2014
Assets		
Current Assets		
Cash and cash equivalents	\$1,088	\$ 5,056
Accounts receivable, net of allowance for doubtful accounts of \$81 and \$60, respectively	5,029	5,661
Notes receivable	71	62
Inventories	825	640
Prepaid expenses and other current assets	4,344	3,423
Advertising cooperative assets, restricted	214	149
Current deferred tax asset	1,536	1,338
Total current assets	13,107	16,329
Property and equipment, net	15,473	12,120
Notes receivable, net of current portion	184	225
Goodwill	106,633	101,082
Trade name and trademarks	87,002	87,002
Definite-life intangibles, net	44,035	44,515
Other assets	284	4,191
Total assets	\$266,718	\$ 265,464
Liabilities and Equity		
Current Liabilities		
Accounts payable	\$5,349	\$ 3,057
Accrued expenses and other current liabilities	8,416	9,600
Advertising cooperative liabilities	307	253
Current portion of unearned franchise and development fees	2,350	2,848
Current portion of long-term debt	2,800	2,800
Total current liabilities	19,222	18,558
Long-term debt, net of current portion	109,976	110,715
Unearned franchise and development fees, net of current portion	460	640
Deferred tax liability	41,799	42,069
Other long-term liabilities	2,109	1,740
Total liabilities	173,566	173,722
Commitments and contingencies (Note 15)		
Equity		
Papa Murphy's Holdings Inc. Shareholders' Equity		
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; 16,919,775 and 16,944,308 shares issued, respectively)	169	169
Additional paid-in capital	118,051	117,354
Stock subscriptions receivable	(100)	(100)
Accumulated deficit	(24,968)	(26,125)
Total Papa Murphy's Holdings Inc. shareholders' equity	93,152	91,298
Noncontrolling interests	—	444
Total equity	93,152	91,742
Total liabilities and equity	\$266,718	\$ 265,464

See accompanying notes.

4

---

Table of ContentsPapa Murphy's Holdings, Inc. and Subsidiaries  
Unaudited Condensed Consolidated Statements of Cash Flows

(In thousands)	Six Months Ended	
	June 29, 2015	June 30, 2014
<b>Operating Activities</b>		
Net income (loss)	\$657	\$(788 )
Net loss attributable to noncontrolling interests	500	—
Net income (loss) attributable to Papa Murphy's	1,157	(788 )
Adjustments to reconcile to cash from operating activities		
Depreciation and amortization	4,739	3,808
Loss on disposal of property and equipment	62	42
Loss on early retirement of debt	—	1,191
Bad debt expense	325	9
Non-cash employee equity compensation	656	1,545
Amortization of deferred finance charges	160	365
Loss on impairment of cost-method investment	4,000	—
Change in operating assets and liabilities		
Accounts receivable	556	(1,978 )
Prepaid expenses and other current assets	(951 )	) 132
Unearned franchise and development fees	(678 )	) (157 )
Accounts payable	1,296	(1,210 )
Accrued expenses and other current liabilities	(521 )	) (1,744 )
Deferred taxes	(468 )	) (706 )
Other assets and liabilities	(603 )	) 19
Cash from operating activities	9,730	528
<b>Investing Activities</b>		
Acquisition of property and equipment	(2,834 )	) (1,085 )
Acquisition of stores, less cash acquired	(9,343 )	) (141 )
Proceeds from sale of stores	—	138
Issuance of notes receivable	(250 )	) —
Payments received on notes receivable	32	948
Investment in cost-method investee	(500 )	) (1,500 )
Cash from investing activities	(12,895 )	) (1,640 )
<b>Financing Activities</b>		
Payments on long-term debt	(1,400 )	) (54,918 )
Advances on revolver, net	500	—
Issuance of common stock, net of underwriting fees	—	59,675
Repurchases of common stock	(10 )	) (1,109 )
Debt issuance and modification costs, including prepayment penalties	—	(6 )
Payments received on subscription receivables	—	1,097
Costs associated with initial public offering	—	(3,490 )
Proceeds from exercise of stock options	51	—
Investment by noncontrolling interest holders	56	167
Cash from financing activities	(803 )	) 1,416
Net change in cash and cash equivalents	(3,968 )	) 304



Edgar Filing: Papa Murphy's Holdings, Inc. - Form 10-Q

Cash and Cash Equivalents, beginning of year	5,056	3,705
Cash and Cash Equivalents, end of period	\$1,088	\$4,009
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for interest	\$2,164	\$6,882
Cash paid during the period for income taxes	1,422	106
Deferred offering costs paid in 2013 reclassified to equity	—	1,537
Noncash Supplemental Disclosures of Investing and Financing Activities		
Acquisition of property and equipment in accounts payable	\$1,074	\$51
See accompanying notes.		

5

---

Table of Contents

Papa Murphy's Holdings, Inc. and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements

Note 1	Description of Business and Basis of Presentation	<u>7</u>
Note 2	Acquisitions and Disposals	<u>8</u>
Note 3	Prepaid Expenses and Other Current Assets	<u>10</u>
Note 4	Property and Equipment	<u>11</u>
Note 5	Goodwill	<u>11</u>
Note 6	Intangible Assets	<u>11</u>
Note 7	Notes Receivable	<u>11</u>
Note 8	Financing Arrangements	<u>12</u>
Note 9	Fair Value Measurement	<u>12</u>
Note 10	Accrued and Other Liabilities	<u>13</u>
Note 11	Income Taxes	<u>13</u>
Note 12	Shareholders' Equity	<u>14</u>
Note 13	Share-based Compensation	<u>14</u>
Note 14	Earnings per Share (EPS)	<u>16</u>
Note 15	Commitments and Contingencies	<u>17</u>
Note 16	Related Party Transactions	<u>18</u>
Note 17	Segment Information	<u>19</u>

Table of Contents

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 Take 'N' Bake pizza franchises and operates Take 'N' Bake pizza stores owned by the Company. As of June 29, 2015, the Company had 1,485 stores consisting of 1,451 domestic stores (1,333 franchised stores and 118 Company-owned stores) across 38 states, plus 34 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.

Public offering and stock split

On May 7, 2014, the Company completed an initial public offering (the "IPO") of 5,833,333 shares of common stock at a price to the public of \$11.00 per share. The Company received net proceeds from the offering of approximately \$54.6 million after offering fees and expenses. The net proceeds, along with additional cash on hand, were used to repay \$55.5 million of the Company's loans outstanding under the Company's then existing senior secured credit facility, after which the Company had \$112.1 million outstanding under the facility with the revolver undrawn.

Immediately prior to the IPO, the Company amended and restated its certificate of incorporation to reflect the conversion of all outstanding Series A Preferred Stock and Series B Preferred Stock (together, the "Preferred Shares") to 3,054,318 shares of common stock. In connection with the IPO, on May 1, 2014, the Company amended its certificate of incorporation to effect a 2.2630 for 1 stock split of its common stock. As a result of the stock split, all previously reported share and option amounts in these interim unaudited condensed consolidated financial statements and accompanying notes have been retrospectively restated to reflect the stock split. After the conversion of the Preferred Shares and the stock split, but before the shares were sold in the IPO, the Company had 11,134,070 common shares outstanding.

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 presentation 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 year ended December 29, 2014.

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 ("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.

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 2015 and 2014 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 2015 and 2014 are references to fiscal years ending December 28, 2015, and ended December 29, 2014, respectively.

Table of Contents

Recent Accounting Pronouncements

In April 2015, the FASB issued ASU 2015-03, Interest – Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs (“ASU 2015-03”). This update requires debt issuance costs related to a recognized debt liability to be presented in the balance sheet as a direct deduction from the carrying value of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs were not affected by this update. The Company early adopted ASU 2015-03 during the three months ended June 29, 2015. As a result of the retrospective adoption, the Company reclassified unamortized debt issuance costs of \$1.3 million as of June 29, 2015, and \$1.5 million as of December 29, 2014, from Deferred finance charges, net to Long-term debt, net of current portion on the Condensed Consolidated Balance Sheets. Adoption of this standard did not impact the Company’s results of operations or cash flows in either the current or previous interim and annual reporting periods.

Note 2 — Acquisitions and Disposals

Project Pie Investment and Disposal

The Company, through a non-wholly owned subsidiary, Project Pie Holdings, LLC (“PPH”), made investments in Project Pie, LLC (“Project Pie”) in the form of Series A Convertible Preferred Units (the “Preferred Units”). Project Pie is a fast casual custom-pizza restaurant chain with stores located throughout the United States, the Philippines and Scotland.

In connection with its investment in Project Pie, PPH had committed as of December 29, 2014, to fund, upon demand, up to an additional \$0.5 million prior to December 2016 through the purchase of additional Series A Preferred Units of Project Pie. During the six months ended June 29, 2015, PPH invested the additional \$0.5 million and satisfied its commitment to Project Pie.

The Company disposed of its ownership interests in PPH on June 29, 2015. Prior to the Company’s disposal of its ownership interests in PPH, it recorded a pre-tax impairment of \$4.5 million to its investment in Project Pie during the three months ended June 29, 2015.

During the three months ended March 30, 2015, the Company determined that Project Pie was a VIE as a result of Project Pie having insufficient equity at risk, but that the Company did not have a variable interest in Project Pie and did not have control. The Company did not account for its investment in Project Pie as an equity method investment as the Company’s investment was in preferred units which contained subordination characteristics substantially different from the common units and were determined to not be in-substance common stock. The Company’s investment was classified as a cost method investment in Other assets.

Acquisitions in 2015

M2AD Acquisition

On March 9, 2015, Papa Murphy’s Company Stores, Inc. (“PMCSI”), a wholly-owned subsidiary of the Company, acquired certain assets used in the operation of six Papa Murphy’s stores in the Seattle, Washington area from M2AD Management, Inc., the previous operator of the six Papa Murphy’s stores (the “M2AD Acquisition”). Transaction costs of \$12,000 associated with the M2AD Acquisition were recognized as Other store operating costs in the Condensed Consolidated Statements of Operations. The total purchase price was \$4.1 million, which included a holdback of \$6,000. As of June 29, 2015, PMCSI retained \$5,000 of the holdback amount. The M2AD Acquisition was funded through existing cash and was accounted for using the acquisition method of accounting whereby operating results subsequent to the acquisition date are included in the interim unaudited condensed consolidated financial statements.

Table of Contents

The fair values of the assets acquired are summarized below (in thousands):

Cash and cash equivalents	\$5
Inventories	39
Prepaid expenses and other current assets	38
Property and equipment	406
Reacquired franchise rights	1,139
Asset retirement obligation	(75 )
Total identifiable net assets acquired	1,552
Goodwill	2,554
Total consideration	\$4,106

Reacquired franchise rights have weighted average useful lives of 6.6 years. Goodwill represents the excess of the purchase price over the net tangible and intangible assets acquired and is expected to be fully deductible for income tax purposes. This goodwill is primarily attributable to the acquired customer bases and, to a lesser extent, economies of scale expected from combining the operations of the acquired entities with the operations of the Company.

Unaudited pro forma information—The following unaudited pro forma consolidated revenues and net (loss) income of the Company give effect to the M2AD Acquisition as if it had occurred as of the beginning of 2014:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Pro forma revenues	\$29,121	\$23,049	\$59,368	\$49,535
Pro forma net (loss) income	\$(1,439 )	\$(1,612 )	\$1,168	\$(733 )

The pro forma information presented in this note includes adjustments for amortization of acquired intangible assets, depreciation of acquired property and equipment and income tax expense. The pro forma information is presented for informational purposes and may not be indicative of the results that would have been obtained had the M2AD Acquisition actually occurred at the beginning of 2014, nor is it intended to be indicative of future operating performance.

Revenues and net income from the acquired stores from the closing date of the M2AD Acquisition included in the Company's Condensed Consolidated Statements of Operations for the three and six months ended June 29, 2015, are as follows:

(in thousands)	Three Months Ended	Six Months Ended
	June 29, 2015	June 29, 2015
Revenues	\$1,279	\$1,564
Net income	105	120

**Other Acquisitions**

PMCSI also acquired all of the assets of 15 stores through six individually immaterial acquisitions during the six months ended June 29, 2015: eight stores in Tennessee, three in Washington, one in Idaho, one in Oregon, one in Texas and one in Colorado. The Tennessee stores were acquired on January 26, 2015, the Idaho store on January 12, 2015, the Oregon store on March 2, 2015, the Texas store on March 9, 2015, the Colorado store on May 4, 2015, and the Washington stores on May 11, 2015 (collectively, the "Other Acquisitions"). The Company incurred transaction costs of \$30,000 associated with the Other Acquisitions that were recognized as Other store operating costs in the Condensed Consolidated Statements of Operations. The aggregate purchase price for the Other Acquisitions was approximately \$5.2 million, which included holdbacks totaling \$78,000 in the aggregate. As of June 29, 2015, PMCSI retained \$8,000 of the aggregate holdback amount. The Other Acquisitions were funded through existing cash and were accounted for using the acquisition method of accounting whereby operating results subsequent to the acquisition date are included in the interim unaudited condensed consolidated financial statements.



Table of Contents

The fair values of the assets acquired are summarized below (in thousands):

Cash and cash equivalents	\$9
Inventories	77
Prepaid expenses and other current assets	64
Property and equipment	1,200
Reacquired franchise rights	1,041
Asset retirement obligation	(169 )
Total identifiable net assets acquired	2,222
Goodwill	2,997
Total consideration	\$5,219

Reacquired franchise rights have weighted average useful lives of 3.4 years. Goodwill represents the excess of the purchase price over the net tangible and intangible assets acquired and is expected to be fully deductible for income tax purposes. This goodwill is primarily attributable to the acquired customer bases and, to a lesser extent, economies of scale expected from combining the operations of the acquired entities with the operations of the Company.

Unaudited pro forma information—The following unaudited pro forma consolidated revenues and net (loss) income of the Company give effect to the Other Acquisitions as if they had occurred as of the beginning of 2014:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Pro forma revenues	\$29,402	\$23,507	\$59,738	\$50,394
Pro forma net (loss) income	\$(1,428 )	\$(1,621 )	\$1,190	\$(803 )

The pro forma information presented in this note includes adjustments for amortization of acquired intangible assets, depreciation of acquired property and equipment and income tax expense. The pro forma information is presented for informational purposes and may not be indicative of the results that would have been obtained had the Other Acquisitions actually occurred at the beginning of 2014, nor is it intended to be indicative of future operating performance.

Revenues and net loss from the acquired stores from the closing date of the Other Acquisitions included in the Company's Condensed Consolidated Statements of Operations for the three and six months ended June 29, 2015, are as follows:

(in thousands)	Three Months Ended	Six Months Ended
	June 29, 2015	June 29, 2015
Revenues	\$1,636	\$2,377
Net loss	(74 )	(124 )

#### Note 3 — Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets consist of the following:

(in thousands)	June 29, 2015	December 29, 2014
Prepaid media development costs <sup>(1)</sup>	\$322	\$593
Prepaid rents and insurance	1,159	620
POS software licenses for resale	1,409	1,800
Other	1,454	410
Total prepaid expenses and other current assets	\$4,344	\$3,423

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

The Company recognizes software license revenue upon the resale of Point of Sale ("POS") software licenses to franchise owners at cost. The income from the sale is included in Lease and other revenues and the related expense is recorded in





Table of Contents

Selling, general and administrative costs on the Condensed Consolidated Statements of Operations. POS software license revenue during the periods reported was as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
POS software license revenue	\$115	\$126	\$301	\$1,926

## Note 4 — Property and Equipment

Property and equipment are net of accumulated depreciation of \$11.3 million and \$9.3 million at June 29, 2015, and December 29, 2014, respectively. Depreciation expense during the periods reported was as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Depreciation expense	\$1,075	\$722	\$2,079	\$1,331

## Note 5 — Goodwill

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

(in thousands)	DOMESTIC COMPANY STORES	DOMESTIC FRANCHISE	TOTAL
Balance at December 29, 2014	\$19,536	\$81,546	\$101,082
Acquisitions	5,551	—	5,551
Balance at June 29, 2015	\$25,087	\$81,546	\$106,633

There is no goodwill associated with the International Segment. During the three months ended June 29, 2015, the Company has determined that there have not been any triggering events that would require an updated impairment review.

## Note 6 — Intangible Assets

Intangible assets are net of accumulated amortization of \$21.9 million and \$19.3 million as of June 29, 2015, and December 29, 2014, respectively. Amortization expense during the periods reported was as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Amortization expense	\$1,345	\$1,245	\$2,660	\$2,477

## Note 7 — Notes Receivable

Notes receivable consist of the following:

(in thousands)	June 29, 2015	December 29, 2014
Note maturing in 2020 bearing interest at 9.0% and collateralized by store assets.	\$255	\$287
Total notes receivable	255	287
Less current portion	(71)	(62)
Notes receivable, net of current portion	\$184	\$225

Table of Contents

## Note 8 — Financing Arrangements

Long-term debt consists of the following:

(in thousands)	June 29, 2015	December 29, 2014
2014 Credit Facility		
Term loan	\$ 110,600	\$ 112,000
Revolving line of credit	500	—
Notes payable	3,000	3,000
Total principal amount of long-term debt	114,100	115,000
Unamortized debt issuance costs	(1,324 )	(1,485 )
Total long-term debt	112,776	113,515
Less current portion	(2,800 )	(2,800 )
Total long-term debt, net of current portion	\$ 109,976	\$ 110,715

## 2014 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 “2014 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. The term loan and any loans made under the revolving credit facility mature in August 2019. As of June 29, 2015, the 2014 Credit Facility bore interest under the LIBOR rate option at 3.44%.

With a maturity date of over one year from June 29, 2015, balances outstanding under the 2014 Credit Facility are classified as non-current on the Condensed Consolidated Balance Sheets, except for mandatory, minimum term loan amortization payments of \$0.7 million due on the last day of each fiscal quarter.

The weighted average interest rate for all borrowings under our 2014 Credit Facility for the second quarter of 2015 was 3.46%.

## 2013 senior secured credit facility

In August 2014, the borrowings under the 2014 Credit Facility refinanced the \$177.0 million senior secured credit facility entered into in October 2013 (the “2013 Credit Facility”), which included a \$167.0 million senior secured term loan and a \$10.0 million revolving credit facility, including a \$2.5 million letter of credit subfacility.

On May 7, 2014, the Company prepaid \$55.5 million of its long-term debt under the 2013 Credit Facility in connection with the IPO. A proportionate share of deferred financing costs of \$1.2 million were expensed as a Loss on early retirement of debt on the Company’s Condensed Consolidated Statements of Operations at the time of this debt prepayment.

## Notes payable

PMCSI has a \$3.0 million note payable which bears interest at 5% and matures in December 2018. This note is subordinated to the 2014 Credit Facility.

## Note 9 — 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.

Table of Contents

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)	June 29, 2015		December 29, 2014		FAIR VALUE MEASUREMENTS
	CARRYING VALUE	FAIR VALUE	CARRYING VALUE	FAIR VALUE	
Financial assets					
Notes receivable <sup>(1)</sup>	\$255	\$259	\$287	\$302	Level 3
Cost-method investments <sup>(2)</sup>	—	—	4,000	5,055	Level 3
Financial liabilities					
Long-term debt, including current portion thereof <sup>(3)</sup>	114,100	114,100	115,000	113,880	Level 3

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

(2) The fair value of cost-method investments was estimated primarily using a discounted cash flow method based on a discount rate, reflecting the applicable credit spread.

(3) The fair value of long-term debt was estimated 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 and accounts payable. 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.

#### Note 10 — Accrued and Other Liabilities

Accrued and other liabilities consist of the following:

(in thousands)	June 29, 2015	December 29, 2014
Accrued compensation and related costs	4,150	3,670
Gift cards and certificates payable	2,105	2,912
Accrued interest and non-income taxes payable	698	745
Convention fund balance	576	271
Advertising and development fund	—	507
Unearned product rebates	—	791
Other	887	704
	\$8,416	\$9,600

#### Note 11 — Income Taxes

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

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
(Benefit from) provision for income taxes	\$(1,160 )	\$(1,112 )	\$460	\$(421 )
(Loss) income before income taxes	(3,099 )	(2,719 )	1,117	(1,209 )
Effective income tax rate	37.4 %	40.9 %	41.2 %	34.8 %

The effective income tax rate for the three months ended June 29, 2015, includes the effect of certain permanent differences between tax reporting purposes and financial reporting purposes and the relative impact of those differences on a small quarterly loss. The effective income tax rate for the three months ended June 30, 2014, includes the effect of certain



Table of Contents

permanent differences between tax reporting purposes and financial reporting purposes and the relative impact of those differences on a small quarterly loss.

The effective income tax rate for the first six months of 2015 includes the effect of a discrete adjustment for the cumulative share-based compensation expense adjustment for certain awards previously considered unlikely to vest. The effective tax rate for the first six months ended June 30, 2014, includes the effect of a separate unfavorable discrete adjustment for an accelerated restricted stock vesting event recorded in early 2014.

## Note 12 — Shareholders' Equity

## Preferred stock

Prior to the IPO, the Company's preferred stock consisted of Series A Preferred Shares and Series B Preferred Shares. The Preferred Shares had a cumulative preferred dividend of 6.00% per year based on an original liquidation value of \$36.68 per share. Upon liquidation of the Company, the holders of the Preferred Shares were entitled to receive the unpaid liquidation value plus accreted dividends before any distribution could be made to the holders of common stock. In addition, the Preferred Shares participated in 20% of all remaining earnings if distributed to common stockholders. The unpaid liquidation value of the Series A and Series B Preferred Shares was \$21.14 and \$26.80 per share, respectively, as of the IPO. At the IPO, the Preferred Shares were converted into 3,054,318 shares of common stock.

## Noncontrolling interests

The Company received the following additional investments by noncontrolling interest holders in PPH during the periods reported:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Additional investment by noncontrolling interest holders in PPH	\$—	\$ 111	\$56	\$ 167

## Note 13 — 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"). With the adoption of the 2014 Plan, the Company has discontinued selling stock and issuing awards under the 2010 Plan, but stock previously purchased and awards previously granted under the 2010 Plan remain outstanding.

The Incentive Plans reserve 2,116,747 common shares for equity incentive awards which can be awarded as incentive stock options, non-qualified stock options, restricted stock awards, and unrestricted stock awards. Under the Incentive Plans, the Company has awarded 580,925 and 610,084 shares of restricted common stock to eligible employees as of June 29, 2015, and December 29, 2014, respectively. In addition, the Company has issued 1,074,800 and 945,149 stock options under the Incentive Plans to eligible employees as of June 29, 2015, and December 29, 2014, respectively.

Table of Contents

## Restricted common shares

Information with respect to restricted stock activity is as follows:

	Number of Shares of Restricted Common Stock		Weighted Average Sale/Grant Date Fair Value Per Share
	Time Vesting	Performance Vesting	
Unvested, December 29, 2014	127,650	215,556	\$2.27
Granted	4,785	—	18.81
Vested	(57,326	) —	0.90
Repurchased	(7,542	) (26,402	) 0.74
Unvested, June 29, 2015	67,567	189,154	\$3.09

The weighted average fair value of share-based compensation awards granted and the fair values of awards granted and vested during the period were as follows:

(in thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Weighted average grant date fair value per share	\$18.81	N/A	\$18.81	N/A
Total fair value of shares granted	90	\$—	90	\$—
Total fair value of shares vested	35	47	52	432

## 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 (in thousands)
	Time Vesting	Performance Vesting			
Outstanding, December 29, 2014	722,307	222,842	\$11.16		
Granted	192,000	—	13.43		
Exercised	(4,626	) —	11.00		
Forfeited	(37,483	) (20,240	) 11.79		
Outstanding, June 29, 2015	872,198	202,602	\$11.54	9.0 years	\$10,215
Exercisable, June 29, 2015	443,363	—	\$11.18	8.8 years	\$4,372
Vested and expected to vest at June 29, 2015	807,873	172,212	\$11.51	9.0 years	\$9,339

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

(in thousands, except per share amounts)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Weighted average grant date fair value per share	N/A	\$4.27	\$5.41	\$4.27
Total fair value of awards granted	\$—	3,367	1,039	4,151
Total fair value of awards vested	314	1,147	324	1,432
Total intrinsic value of options exercised	—	—	32	—

Table of Contents

## Compensation cost and valuation

Total compensation costs recognized in connection with the Incentive Plans during the periods reported were as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Stock compensation expense	\$500	\$995	\$656	\$1,545
Income tax benefits associated with stock compensation expense	166	393	218	509

As of June 29, 2015, the total unrecognized stock-based compensation expense, net of estimated forfeitures, was \$3.0 million with \$2.1 million associated with time vesting awards and \$0.9 million associated with performance vesting awards. The remaining weighted average contractual life for unrecognized stock-based compensation expense was 3.5 years as of June 29, 2015.

Prior to the IPO, the valuation of the Company's common stock and Preferred Shares was based on the principles of option-pricing theory. This approach is based on modeling the value of the various components of an entity's capital structure as a series of call options on the proceeds expected from the sale of the entity or the liquidation of its assets at some future date. Specifically, each of the preferred and common equity is modeled as a call option on the aggregate value of the Company with an exercise price equal to the liquidation preferences of the more senior securities. Both the income and market approaches were considered when estimating the fair value of the Company. The Company's valuation was performed under both an IPO and non-IPO scenario with each value weighted based on an estimated probability of occurrence. The key inputs required to calculate the value of the common stock using the option-pricing model included the risk free rate, the volatility of the underlying assets, and the estimated time until a liquidation event. The Company applied a marketability discount to the value of common stock based on facts and circumstances at each valuation date.

During the reported periods prior to the IPO, the Company assumed the following:

	Three Months Ended March 31, 2014 <sup>(1)</sup>	
	IPO Scenario	Non-IPO Scenario
Risk free rate	0.36%	0.36%
Volatility of the underlying assets	45%	45%
Estimated time until a liquidation event	0.58 years	1.75 years
Marketability discount—common stock	10%	25%
Marketability discount—preferred stock	8%	15%
Weight applied to scenario	95%	5%

(1) The last valuation of the Company was performed as of March 31, 2014.

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

	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Risk free rate	N/A	2.1%	1.9%	2.0%
Expected volatility	N/A	34.9%	37.9%	35.0%
Expected term	N/A	6.5 years	6.3 years	6.3 years
Expected dividend yield	N/A	0.0%	0.0%	0.0%

## Note 14 — 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. Prior to the IPO, the Company's cumulative preferred

stockholders were entitled to participate in 20% of all remaining earnings or dividends if distributed to common stockholders. As such, the

16

---



Table of Contents

Company calculated EPS using the two-class method. The two-class method determines EPS for common stock and participating securities according to dividends and dividend equivalents and their respective participation rights in undistributed earnings.

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 potential common shares would have an anti-dilutive effect.

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

(in thousands, except per share data)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Earnings:				
Net (loss) income	\$ (1,939 )	\$ (1,607 )	\$ 657	\$ (788 )
Less: net loss attributable to noncontrolling interests	500	—	500	—
Net (loss) income attributable to Papa Murphy's	(1,439 )	(1,607 )	1,157	(788 )
Less: cumulative Series A and B Preferred dividends	—	(552 )	—	(2,150 )
Net (loss) income available to common shareholders	\$ (1,439 )	\$ (2,159 )	\$ 1,157	\$ (2,938 )
Shares:				
Weighted average common shares outstanding	16,630	11,375	16,617	7,613
Dilutive effect of potential common stock <sup>(1)</sup>	—	—	256	—
Diluted weighted average number of shares outstanding	16,630	11,375	16,873	7,613
(Loss) earnings per share:				
Basic (loss) earnings per share	\$ (0.09 )	\$ (0.19 )	\$ 0.07	\$ (0.39 )
Diluted (loss) earnings per share	\$ (0.09 )	\$ (0.19 )	\$ 0.07	\$ (0.39 )

The Company's potential common stock instruments such as stock options and restricted stock were not included in (1) the computation of diluted EPS for the three and six months ended June 30, 2014 and the three months ended June 29, 2015, as the effect of including these shares in the calculation would have been anti-dilutive.

For the three months ended June 29, 2015, and June 30, 2014, an aggregated total of 390,000 shares and 388,000 shares, respectively, have been excluded from the diluted income per share calculation because their effect would have been anti-dilutive. For the six months ended June 29, 2015, and June 30, 2014, an aggregated total of 88,000 shares and 341,000 shares, respectively, have been excluded from the diluted income per share calculation because their effect would have been anti-dilutive.

#### Note 15 — Commitments and Contingencies

##### Operating lease commitments

The Company leases facilities and various office equipment under non-cancelable operating leases which expire through December 2025. Lease terms for its store units are generally for five years with renewal options and generally require the Company to pay a proportionate share of real estate taxes, insurance, common area, and other operating costs.

The Company has entered into operating leases that it has subleased to three franchised stores. These operating leases have minimum base rent terms, contingent rent terms if individual franchised store sales exceed certain levels and have terms expiring on various dates from October 2015 to May 2020.

##### Lease guarantees

The Company is the guarantor for operating leases of eight franchised stores that have terms expiring on various dates from July 2015 to September 2018. 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 June 29, 2015, the Company does not believe it is probable it would be required to perform under the outstanding guarantees.



Table of Contents

Legal proceedings

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 12 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 completed mediating with the Company in good faith.

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 done so.

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 reached resolution with eleven 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 plaintiffs 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. The Company has filed an answer denying the material allegations of the amended complaint.

The Company believes the allegations in these consolidated lawsuits lack merit and, for those plaintiffs with whom the Company is unable to reach resolution, 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 these lawsuits; however, it does not currently expect the cost of resolving them to have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

On May 8, 2015, the Company was named as a defendant in a class action lawsuit claiming a violation of the Telephone Consumer Protection Act, which prohibits companies from making telemarketing calls to numbers listed in the Federal Do-Not-Call Registry and imposes other obligations and limitations on making phone calls and sending text messages to consumers. The lawsuit alleges that the Company did not comply with the statutory requirements for obtaining consumers' consent to receive text messages from the Company, and seeks statutory penalties for those alleged deficiencies. The Company believes the plaintiff's interpretation of the applicable law is incorrect, and it will vigorously defend itself in the lawsuit, but provides no assurance that it will be successful. An adverse judgment or settlement could have an adverse impact on the Company's profitability and could cause variability in its results compared to expectations.

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 16 — Related Party Transactions

Advisory services and monitoring agreement

Prior to the IPO, the Company was a party to an advisory services and monitoring agreement with affiliates of Lee Equity Partners, LLC (“Lee Equity”). In accordance with the terms of the agreement, the Company paid Lee Equity for ongoing

Table of Contents

advisory and monitoring services, such as management consulting, financial analysis, and other related services. As compensation, the Company paid an annual fee of \$0.5 million in four equal quarterly installments plus direct expenses incurred which are included in Selling, general and administrative costs. The agreement did not call for a minimum level of services to be furnished and provided that fees paid to Lee Equity could be deferred at the discretion of Lee Equity or to the extent required under the Company's 2014 Credit Facility.

On May 7, 2014, the Company completed the IPO and paid Lee Equity \$1.5 million in accordance with the terms of the agreement. With the completion of the IPO, the advisory services and monitoring agreement between the Company and Lee Equity was terminated.

Employee loans related to share purchases

In connection with share-based compensation, the Company has made several loans to certain officers and non-officer employees of the Company (see Note 13 — Share-based Compensation). Loans made in connection with the issuance of the Company's equity have been recognized in Stock subscriptions receivable as a reduction of total equity.

In March 2014, the Company entered into agreements with certain executive officers to repurchase an aggregate of 109,779 shares of common stock at a price of \$11.85 per share for a total purchase price of \$1.3 million. Included among the repurchased shares were 31,707 shares of common stock for which vesting terms were accelerated in connection with the repurchase. The Company received a payment of \$1.0 million from the same executive officers to repay their outstanding stock subscription receivables. Concurrent with the share repurchase, the Company entered into agreements with the same executive officers to issue 109,779 stock options to purchase shares at an exercise price of \$11.85 per share, including 78,072 fully vested options and 31,707 options subject to time-based or performance-based vesting provisions. In connection with the acceleration of vesting and the issuance of the fully vested options, the Company recorded stock-based compensation expense of \$0.5 million for the six months ended June 30, 2014.

All loans made to officers of the Company were repaid prior to the IPO. Some loans made to non-officer employees of the Company were still outstanding at the time of the IPO. As of June 29, 2015, and December 29, 2014, the Company had stock subscription receivables of \$0.1 million.

Related party revenue

The Company was party to transactions to sell services to Project Pie during the period Project Pie was a cost-method investee. Revenue from these transactions are recorded as Lease and other revenues on the Condensed Consolidated Statements of Operations. Related party revenue during the periods reported was as follows:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Related party revenue	\$—	\$45	\$4	\$84

As of June 29, 2015, and December 29, 2014, the Company had an Accounts receivable balance from Project Pie of \$0 and \$66,000, respectively.

Notes receivable

On March 13, 2015, the Company loaned Project Pie, a cost-method investee, \$250,000, in exchange for a note receivable which bore interest at 13% and matured in June 2015. This note was written off as a bad debt in the three months ended June 29, 2015.

In June 2015, the Company entered into an agreement with Project Pie under which the Company, at its own discretion, may advance funds not to exceed \$0.8 million in exchange for a subordinated note receivable. As of June 29, 2015, no funds were outstanding under the agreement.

Note 17 — Segment Information

The Company has the following reportable segments: (i) Domestic Company Stores; (ii) Domestic Franchise; and (iii) International. The Domestic Company Stores segment includes operations with respect to Company-owned stores in the United States and derives its revenues from retail sales of pizza and side items to the general public. The Domestic Franchise segment includes operations with respect to franchised stores in the United States and derives its revenues



Table of Contents

primarily from franchise and development fees and franchise royalties from franchised stores in the United States. The International segment includes operations related to the Company's operations outside the United States and derives its revenues from franchise and development fees and franchise royalties from franchised stores outside the United States.

The following tables summarize information on profit or loss and assets for each of the Company's reportable segments:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Revenues				
Domestic Franchise	\$10,878	\$10,324	\$22,813	\$23,371
Domestic Company Stores	18,156	11,477	35,323	23,495
International	87	45	154	97
Total	\$29,121	\$21,846	\$58,290	\$46,963
Segment Operating Income (Loss)				
Domestic Franchise	\$4,208	\$4,234	\$10,135	\$10,228
Domestic Company Stores	552	158	1,688	678
International	54	(121)	78	(225)
Corporate and unallocated	(2,226)	(3,459)	(3,965)	(5,269)
Total	\$2,588	\$812	\$7,936	\$5,412
Depreciation and Amortization				
Domestic Franchise	\$1,288	\$1,261	\$2,589	\$2,430
Domestic Company Stores	1,124	698	2,135	1,363
International	8	8	15	15
Total	\$2,420	\$1,967	\$4,739	\$3,808
(in thousands)			June 29, 2015	December 29, 2014
Total Assets				
Domestic Franchise			\$132,156	\$137,417
Domestic Company Stores			44,548	34,953
International			392	447
Other <sup>(1)</sup>			89,622	92,647
Total			\$266,718	\$265,464

(1) Other assets which are not allocated to the individual segments primarily include trade names and trademarks, unamortized deferred financing charges, and an intercompany note.

## Table of Contents

### 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 consolidated financial statements and the related notes included in our Annual Report on Form 10-K. 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 years 2015 and 2014 are 52-week periods ending on December 28, 2015, and ended on December 29, 2014, respectively.

#### 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 this Quarterly Report on Form 10-Q. 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, business strategies and priorities, resolution of litigation and claims, expectations for reducing operating costs and increasing sales through the use of our POS system terminals, deductibility of goodwill for income tax purposes, potential efficiencies and synergies created by store acquisitions, expansion and growth opportunities, the number and timing of new store openings, exposure to foreign currency and interest rate risk, retention of senior executives, as well as industry trends and outlooks. These statements may include words such as "anticipate," "estimate," "expect," "project," "plan," "intend," "believe," "may," "should," "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 under 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 this Quarterly Report on Form 10-Q. 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.

#### Overview

Papa Murphy's is a franchisor and operator of the largest Take 'N' Bake pizza chain in the United States and the fifth largest pizza chain overall. We were founded in 1981 and have grown our footprint to a total of 1,485 system-wide stores as of June 29, 2015, of which 92.1% are franchised, located in 38 states plus Canada and the Middle East. We have been repeatedly rated the #1 pizza chain in the United States by multiple third-party consumer studies. In 2015, Technomic awarded us the 2015 Chain Restaurant Consumers' Choice award and named us the Quick Serve concept most likely to be recommended by consumers. Nation's Restaurant News rated us the #1 limited service restaurant in the Pizza/Italian Category for 2015. We were rated #1 in the Pizza Category by Market Force



Information in 2015, including the top spot in food quality, healthy food, and friendly service. We were also rated the #1 pizza chain overall by Nation's Restaurant News in 2014, 2013, 2012 and 2011. When compared to broader restaurant chain competition, we were recognized by

Table of Contents

Technomic in 2015, 2014 and 2013 as the #1 chain overall among all restaurants and all food categories and by Nation's Restaurant News in 2013 and 2012 as one of the Top 5 Overall limited service restaurant chains across all food categories.

Our financial results are driven largely by system-wide sales at our franchised and Company-owned stores.

System-wide sales are driven by comparable store sales growth and store count, which translate into royalty payments from franchise owners, as well as Company-owned store revenues. We strive to consistently increase both comparable store sales and our store counts. Total revenues can also be impacted by acquisitions of franchised stores by our Domestic Company Stores segment or the refranchising of Company-owned stores.

The Take 'N' Bake model offers operating advantages that differentiate us from other restaurant concepts. Our domestic stores (i) do not require ovens, freezers or other expensive cooking equipment because our customers bake their customized pizzas at home; (ii) do not offer delivery, thereby reducing operational complexity for franchise owners and their employees; (iii) maintain shorter opening hours (typically 11:00 a.m. to 9:00 p.m.) that are attractive to franchise owners and their employees; (iv) require fewer employees during each shift compared to most other restaurant concepts, resulting in lower labor costs; and (v) do not require dining areas, resulting in lower occupancy and operating costs.

The relatively small initial and ongoing investments required to own and operate a Papa Murphy's store creates the opportunity for higher margins and attractive returns. We believe these favorable investment requirements coupled with simple operations, a strong brand message supported by high levels of advertising spending and high-quality menu offerings drive attractive store-level economics, which, in turn, drives demand for new stores.

**2015 Highlights****Revenue Growth**

Total revenues for the three months ended June 29, 2015, compared to the three months ended June 30, 2014, grew 33.3% from \$21.8 million to \$29.1 million due primarily to the strategic acquisition of franchised stores by our Domestic Company Stores segment, new store openings, and comparable store sales growth. Total revenues for the six months ended June 29, 2015, compared to the six months ended June 30, 2014, grew 24.1% from \$47.0 million to \$58.3 million due primarily to the strategic acquisition of franchised stores by our Domestic Company Stores segment, new store openings, and comparable store sales growth. Excluding the year-over-year impact of POS licenses resold to franchisees at cost, total revenue increased 33.5% and 28.8% in the three and six months ended June 29, 2015, respectively, over the comparable periods in 2014.

System-wide sales for the three months ended June 29, 2015, compared to the three months ended June 30, 2014, increased 7.5% from \$200.7 million to \$215.8 million. System-wide sales for the six months ended June 29, 2015, compared to the six months ended June 30, 2014, increased 8.1% from \$416.7 million to \$450.4 million.

Comparable store sales growth in 2015 compared to 2014 for selected segments was as follows:

	Three Months Ended		Six Months Ended			
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014		
Domestic Franchise	4.5	% 1.2	% 5.0	% 2.2	%	
Domestic Company Stores	4.9	% 5.7	% 5.6	% 6.4	%	
Total domestic stores	4.5	% 1.5	% 5.1	% 2.5	%	

As of June 29, 2015, we had achieved 18 straight quarters of comparable store sales growth and 41 of the last 46 quarters had positive comparable store sales growth. In the six months ended June 29, 2015, we also had 17 weeks in which we recorded all-time highs for system-wide sales.

**Store Development**

We and our franchise owners opened 20 stores in the three months ended June 29, 2015, including 16 in the United States. Through the six months ended June 29, 2015, we and our franchise owners opened 42 stores, including 36 in the United States. While we plan to strategically expand our Company-owned store base in select markets, we expect the majority of our expansion will result from new franchised store openings.



Table of Contents

## Acquisitions

During the three months ended June 29, 2015, we acquired three stores in the Seattle, Washington market and one in the Colorado Springs, Colorado market. During the six months ended June 29, 2015, we acquired 21 Papa Murphy's stores from franchise owners in six different markets across the country. Nine stores were acquired in the Seattle, Washington market, eight stores in the Knoxville, Tennessee market, and one store each in the Boise, Idaho; Portland, Oregon; Dallas, Texas; and Colorado Springs, Colorado markets.

## Technology Investments

Our POS system is an important technology platform and tool for our future growth. Future precision marketing tools and mobile coupon capabilities necessitate POS system terminals in our stores. We have rolled out POS system terminals to 1,084 stores as of June 29, 2015. We believe that an opportunity remains for many of our franchise owners to reduce their operating costs by using the POS system terminals.

We continue to roll out an integrated online ordering platform coupled with the latest version of our POS system software, which was in 698 stores as of June 29, 2015. An additional 56 stores were still on our original, non-integrated online ordering platform pending conversion as of June 29, 2015.

## Our Segments

We operate in three business segments: Domestic Franchise, Domestic Company Stores and International. Our Domestic Franchise segment consists of our domestic franchised stores, which represent the majority of our system-wide stores. Our Domestic Company Stores segment consists of our Company-owned stores in the United States. Our International segment consists of our stores outside of the United States, all of which are franchised. The following table sets forth our Revenues, Operating Income and Depreciation and amortization for each of our segments for the periods presented:

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Revenues				
Domestic Franchise	\$10,878	\$10,324	\$22,813	\$23,371
Domestic Company Stores	18,156	11,477	35,323	23,495
International	87	45	154	97
Total	\$29,121	\$21,846	\$58,290	\$46,963
Operating Income				
Domestic Franchise	\$4,208	\$4,234	\$10,135	\$10,228
Domestic Company Stores	552	158	1,688	678
International	54	(121 )	78	(225 )
Other <sup>(1)</sup>	(2,226 )	(3,459 )	(3,965 )	(5,269 )
Total	\$2,588	\$812	\$7,936	\$5,412
Depreciation and amortization				
Domestic Franchise	\$1,288	\$1,261	\$2,589	\$2,430
Domestic Company Stores	1,124	698	2,135	1,363
International	8	8	15	15
Total	\$2,420	\$1,967	\$4,739	\$3,808

(1) Represents corporate costs and intersegment elimination.

Table of Contents

## 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		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Domestic store average weekly sales (AWS)	\$11,342	\$10,848	\$11,868	\$11,296
Domestic comparable store sales growth	4.5	% 1.5	% 5.1	% 2.5
Domestic comparable stores	1,363	1,309	1,363	1,309
System-wide sales (in thousands)	\$215,752	\$200,718	\$450,385	\$416,701
Number of system-wide stores at period end	1,485	1,436	1,485	1,436
Adjusted EBITDA (in thousands)	\$6,432	\$5,687	\$14,447	\$13,220

## Average Weekly Sales

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

## Comparable Store Sales Growth

Comparable store sales growth represents the change in year-over-year sales for comparable stores. A comparable store is a store that has been open for at least 52 full weeks from the comparable date (the Tuesday following the opening date). This measure highlights the performance of existing stores, while excluding the effect of newly opened or closed stores. Comparable store sales growth 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 include 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 acquisitions and divestitures of stores to assess growth in system-wide sales, royalty revenues and Company-owned store sales.

The following table sets forth the changes in the number of stores in our system as well as the rate of new store openings for the six months ended June 29, 2015.

	Domestic Company Stores	Domestic Franchise	Total Domestic	International	Total	Annualized New Store Opening Rate
Store count at December 29, 2014	91	1,342	1,433	28	1,461	
Openings	7	29	36	6	42	5.7 %
Closings	(1	) (17	) (18	) —	(18	)
Net transfers	21	(21	) —	—	—	
Store count at June 29, 2015	118	1,333	1,451	34	1,485	

## EBITDA and Adjusted EBITDA

To supplement our 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

Table of Contents

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:

all non-cash losses or expenses (including non-cash share-based compensation expenses and the non-cash portion of rent expenses relating to the difference between GAAP and cash rent expenses), excluding any non-cash loss or expense that is an accrual of a reserve for a cash expenditure or payment to be made, or anticipated to be made, in a future period;

non-recurring or unusual cash fees, costs, charges, losses and expenses;

fees, costs and expenses related to acquisitions;

pre-opening costs with respect to new stores;

historical management fees and expenses incurred under our advisory services and monitoring agreement with Lee Equity, which terminated in connection with the IPO; and

fees and expenses incurred in connection with the issuance of debt.

Adjusted EBITDA eliminates 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 non-cash items and about 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, as well as 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:

as a measurement used 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;

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.

Table of Contents

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

(in thousands)	Three Months Ended		Six Months Ended	
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014
Net (Loss) Income	\$(1,939 )	\$(1,607 )	\$657	\$(788 )
Net loss attributable to noncontrolling interests	500	—	500	—
Net (Loss) Income Attributable to Papa Murphy's	(1,439 )	(1,607 )	1,157	(788 )
Depreciation and amortization	2,420	1,967	4,739	3,808
Income tax provision (benefit)	(1,160 )	(1,112 )	460	(421 )
Interest expense, net	1,143	2,297	2,273	5,375
EBITDA	964	1,545	8,629	7,974
Loss on disposal of property and equipment <sup>(1)</sup>	3	36	62	42
Expenses not indicative of future operations:				
Secondary offering and IPO preparation costs <sup>(2)</sup>	345	278	345	651
Loss on Project Pie impairment and disposal <sup>(3)</sup>	4,325	—	4,325	—
Management fees and related expenses <sup>(4)</sup>	—	1,543	—	1,678
Transaction costs <sup>(5)</sup>	29	60	63	62
New store pre-opening expenses <sup>(6)</sup>	176	1	246	11
Non-cash expenses and non-income based state taxes <sup>(7)</sup>	590	1,033	777	1,611
Loss on early retirement of debt <sup>(8)</sup>	—	1,191	—	1,191
Adjusted EBITDA	\$6,432	\$5,687	\$14,447	\$13,220

(1) Represents non-cash losses resulting from disposal of property and equipment, including divested Company-owned stores.

For the 2015 periods, represents offering costs related to the secondary offering of the Company's common stock;

(2) For the 2014 periods, represents non-recurring advisory expenses in connection with our IPO and non-recurring recruitment, relocation and other costs related to the recruitment of a new CFO.

(3) Represents a \$4 million loss recognized upon impairment of Project Pie, a cost-method investment, and its subsequent disposal, and the write-off as bad debt receivables totaling \$325,000.

(4) Represents the elimination of management fees and related costs paid to Lee Equity for advisory services provided pursuant to an advisory services and monitoring agreement. More information can be found in Financial Statements in Note 16 — Related Party Transactions of the accompanying Notes to Unaudited Condensed Consolidated Financial Statements

(5) Represents transaction costs relating to the acquisition of multiple franchised stores and the investments in and divestment of Project Pie.

(6) Represents expenses directly associated with the opening of new stores and incurred primarily in advance of the store opening, including wages, benefits, and travel for training of opening teams, grand opening marketing costs and other store operating costs.

(7) Represents (i) non-cash expenses related to equity-based compensation; (ii) non-cash expenses related to the difference between GAAP and cash rent expense; and (iii) state revenue taxes levied in lieu of an income tax.

(8) Represents losses resulting from refinancing of long-term debt.

#### Key Financial Definitions

##### Revenues

Substantially all of our revenues are derived from 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. Franchise and development fees include initial franchise fees charged for opening a new franchised store, successive fees for the renewal of expiring franchise agreements, transfer fees for transferring ownership of a franchise and fee forfeitures. "Lease and other," as used in this report, includes revenues earned from the sublease of real estate under a master lease agreement with a national retailer and revenues derived from the resale of POS system licenses to franchise owners at cost, plus revenue from POS support agreements. Lease income is

recognized in the period earned, which coincides with the period the expense is due to the master leaseholder. See Selling, General and Administrative Costs below for the related offsetting expense to the POS system licenses resold to franchise owners.

**Store Operating Costs**

Store operating costs relate to our Domestic Company Stores segment and consist of Cost of food and packaging, Compensation and benefits, Advertising, Occupancy costs and Other store operating costs. We expect all of our Store operating costs to vary as our store count changes from building or acquiring new Company-owned stores. Cost of food and



Table of Contents

packaging and Advertising can be expected to fluctuate predominantly with the increases or decreases in Revenues of our Domestic Company Stores segment.

**Selling, General and Administrative Costs**

Selling, general and administrative costs consist of wages, benefits and other compensation, franchise development expenses, travel, marketing, accounting and legal fees, the costs of POS system software licenses sold to franchise owners at cost, sponsor management fees and other expenses related to the infrastructure required to support our franchised and Company-owned stores. See Revenues above for a discussion of the related offsetting revenue from the POS system software licenses resold to franchise owners. Selling, general and administrative costs also include net advertising expenses of an advertising fund we manage on behalf of all domestic stores.

**Depreciation and Amortization**

Depreciation and amortization constitute non-cash charges related to the depreciation of fixed assets, including leasehold improvements and equipment, and the amortization of franchise relationships and reacquired franchise rights relating to our acquisition of certain franchised stores.

Table of Contents

## 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 six months ended June 29, 2015, and June 30, 2014.

(in thousands)	Three Months Ended June 29, 2015			June 30, 2014			Six Months Ended June 29, 2015			June 30, 2014		
	\$	TOTAL % OF REVENUES		\$	TOTAL % OF REVENUES		\$	TOTAL % OF REVENUES		\$	TOTAL % OF REVENUES	
<b>Revenues</b>												
Franchise royalties	\$9,753	33.5	%	\$9,315	42.7	%	\$20,433	35.0	%	\$19,384	41.3	%
Franchise and development fees	830	2.9	%	862	3.9	%	1,970	3.4	%	2,031	4.3	%
Company-owned store sales	18,156	62.3	%	11,477	52.5	%	35,323	60.6	%	23,495	50.0	%
Lease and other	382	1.3	%	192	0.9	%	564	1.0	%	2,053	4.4	%
<b>Total revenues</b>	<b>29,121</b>	<b>100.0</b>	<b>%</b>	<b>21,846</b>	<b>100.0</b>	<b>%</b>	<b>58,290</b>	<b>100.0</b>	<b>%</b>	<b>46,963</b>	<b>100.0</b>	<b>%</b>
<b>Costs and Expenses</b>												
<b>Store operating costs:</b>												
Cost of food and packaging <sup>(1)</sup>	6,443	22.2	%	4,499	20.6	%	12,533	21.5	%	9,089	19.5	%
Compensation and benefits <sup>(1)</sup>	4,722	16.2	%	2,905	13.3	%	9,076	15.6	%	5,935	12.6	%
Advertising <sup>(1)</sup>	1,753	6.0	%	1,122	5.1	%	3,422	5.9	%	2,244	4.8	%
Occupancy <sup>(1)</sup>	1,174	4.0	%	674	3.1	%	2,176	3.7	%	1,334	2.8	%
Other store operating costs <sup>(1)</sup>	1,856	6.4	%	1,007	4.6	%	3,301	5.7	%	2,076	4.4	%
Selling, general and administrative	8,162	28.0	%	8,824	40.4	%	15,045	25.8	%	17,023	36.2	%
Depreciation and amortization	2,420	8.3	%	1,967	9.0	%	4,739	8.1	%	3,808	8.1	%
Loss on disposal of property and equipment	3	—	%	36	0.2	%	62	0.1	%	42	0.1	%
<b>Total costs and expenses</b>	<b>26,533</b>	<b>91.1</b>	<b>%</b>	<b>21,034</b>	<b>96.3</b>	<b>%</b>	<b>50,354</b>	<b>86.4</b>	<b>%</b>	<b>41,551</b>	<b>88.5</b>	<b>%</b>
<b>Operating Income</b>	<b>2,588</b>	<b>8.9</b>	<b>%</b>	<b>812</b>	<b>3.7</b>	<b>%</b>	<b>7,936</b>	<b>13.6</b>	<b>%</b>	<b>5,412</b>	<b>11.5</b>	<b>%</b>
Interest expense	1,149	3.8	%	2,316	10.5	%	2,292	3.9	%	5,428	11.6	%
Interest income	(6 )	—	%	(19 )	(0.1 )	%	(19 )	0.0	%	(53 )	(0.1 )	%
Loss on early retirement of debt	—	—	%	1,191	5.5	%	—	—	%	1,191.0	2.5	%
Loss on disposal or impairment of investments	4,500	15.5	%	—	—	%	4,500	7.7	%	—	—	%
Other expense, net	44	0.2	%	43	0.2	%	46	0.1	%	55	0.1	%
<b>(Loss) Income Before Income Taxes</b>	<b>(3,099 )</b>	<b>(10.6 )</b>	<b>%</b>	<b>(2,719 )</b>	<b>(12.4 )</b>	<b>%</b>	<b>1,117</b>	<b>1.9</b>	<b>%</b>	<b>(1,209 )</b>	<b>(2.6 )</b>	<b>%</b>
<b>(Benefit from) provision for income taxes</b>	<b>(1,160 )</b>	<b>(3.9 )</b>	<b>%</b>	<b>(1,112 )</b>	<b>(5.0 )</b>	<b>%</b>	<b>460</b>	<b>0.8</b>	<b>%</b>	<b>(421 )</b>	<b>(0.9 )</b>	<b>%</b>
<b>Net (Loss) Income</b>	<b>\$(1,939 )</b>	<b>(6.7 )</b>	<b>%</b>	<b>\$(1,607 )</b>	<b>(7.4 )</b>	<b>%</b>	<b>\$657</b>	<b>1.1</b>	<b>%</b>	<b>\$(788 )</b>	<b>(1.7 )</b>	<b>%</b>
Net loss attributable to noncontrolling interests	500	(1.8 )	%	—	—	%	500	(0.9 )	%	—	—	%
	<b>\$(1,439 )</b>	<b>(4.9 )</b>	<b>%</b>	<b>\$(1,607 )</b>	<b>(7.4 )</b>	<b>%</b>	<b>\$1,157</b>	<b>2.0</b>	<b>%</b>	<b>\$(788 )</b>	<b>(1.7 )</b>	<b>%</b>

Net (Loss) Income  
 Attributable to Papa  
 Murphy's

(1) Please see the table presented in Costs and Expenses below, which presents company-owned store expenses as a percentage of company-owned store revenue for the three and six months ended June 29, 2015, and June 30, 2014.

Revenues

Total revenues. The following table presents Total revenues for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended			Change	%
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change		
Total revenues	\$29,121	\$21,846	33.3	% \$58,290	\$46,963	24.1	%	

28

---

Table of Contents

In the three months ended June 29, 2015, Total revenues grew primarily from the acquisition of franchised stores and construction of new stores by our Domestic Company Stores segment, plus domestic comparable store sales growth of 4.5%. Excluding the year-over-year impact of POS licenses resold to franchisees at cost, total revenue increased 33.5%.

In the six months ended June 29, 2015, Total revenues grew primarily from the acquisition of franchised stores by our Domestic Company Stores segment, net new store openings and domestic comparable store sales growth of 5.1%. Excluding the year-over-year impact of POS licenses resold to franchisees at cost, total revenue increased 28.8%. Franchise royalties. The following table presents Franchise royalties for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Franchise royalties	\$9,753	\$9,315	4.7 %	\$20,433	\$19,384	5.4 %
Percentage of total revenues	33.5 %	42.7 %		35.0 %	41.3 %	

Franchise royalties increased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, primarily due to Domestic Franchise comparable store sales growth of 4.5%. Franchise royalties increased in the six months ended June 29, 2015, compared to the six months ended June 30, 2014 primarily due to Domestic Franchise comparable store sales growth of 5.0%.

The decrease in Franchise royalties as a percentage of Total revenues was the result of increases in the number of Company-owned stores which generated Company-owned store sales increases of 58.2% and 50.3% in the three and six months ended June 29, 2015, respectively, compared to the respective three and six months ended June 30, 2014. Franchise and development fees. The following table presents Franchise and development fees for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Franchise and development fees	\$830	\$862	(3.7)%	\$1,970	\$2,031	(3.0)%
Percentage of total revenues	2.9 %	3.9 %		3.4 %	4.3 %	

Franchise and development fees decreased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, due to the opening of six fewer franchised stores than in the three months ended June 30, 2014. For the six months ended June 29, 2015, Franchise and development fees decreased, compared to the six months ended June 30, 2014, due to the opening of six fewer franchised stores than in the six months ended June 30, 2014.

Company-owned store sales. The following table presents Company-owned store sales for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Company-owned store sales	\$18,156	\$11,477	58.2 %	\$35,323	\$23,495	50.3 %
Percentage of total revenues	62.3 %	52.5 %		60.6 %	50.0 %	

Company-owned store sales increased in the three months ended June 29, 2015 compared to prior year due to the acquisition of 43 company-owned stores, the opening of nine new stores, and comparable store sales growth of 4.9%, which was partially offset by the closure of two stores.

In the six months ended June 29, 2015, Company-owned store sales increased due to the acquisition of 43 company-owned stores, the opening of nine stores, and comparable store sales growth of 5.6%, which was partially offset by the closure of two stores and the divestiture of one store. The comparable store sales increases resulted primarily from improved product mix.

Table of Contents

Lease and other. The following table presents Lease and other revenue for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Lease and other	\$382	\$192	99.0 %	\$564	\$2,053	(72.5 )%
Percentage of total revenues	1.3	% 0.9	%	1.0	% 4.4	%

Lease and other revenues increased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, due to help desk fees recognized from new POS support agreements and breakage on a discontinued gift certificate program. During the quarter the Company began to provide help desk support to franchised and Company-owned stores for a recurring quarterly fee. Lease and other revenue decreased in the six months ended June 29, 2015, compared to the six months ended June 30, 2014, due to a reduction of \$1.6 million from the resale of POS software licenses to franchise owners at cost. An equal and offsetting cost related to the resale of the POS software licenses is included in Selling, general and administrative expenses as discussed below.

## Costs and Expenses

Total costs and expenses. The following table presents Total costs and expenses for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Total costs and expenses	\$26,533	\$21,034	26.1 %	\$50,354	\$41,551	21.2 %
Percentage of total revenues	91.1	% 96.3	%	86.4	% 88.5	%

Total costs and expenses increased in the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014, primarily as the result of store acquisitions from franchise owners and the opening of new Company-owned stores.

Store operating costs. The following table presents Store operating costs for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Store operating costs	\$15,948	\$10,207	56.2 %	\$30,508	\$20,678	47.5 %
Percentage of total revenues	54.8	% 46.7	%	52.3	% 44.0	%

Store operating costs as a percentage of total revenues increased in the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014, primarily as a result of the acquisition of stores from franchise owners and the construction of new stores.

The following table presents a break-out of Store operating costs as a percentage of Company-owned store sales for the periods reported:

	Three Months Ended		Six Months Ended		
	June 29, 2015	June 30, 2014	June 29, 2015	June 30, 2014	
As a % of Company-owned store revenue:					
Cost of food and packaging	35.5	% 39.2	% 35.5	% 38.7	%
Compensation and benefits	26.0	% 25.3	% 25.7	% 25.3	%
Advertising	9.7	% 9.8	% 9.7	% 9.6	%
Occupancy	6.5	% 5.9	% 6.2	% 5.7	%
Other store operating costs	10.1	% 8.7	% 9.3	% 8.7	%
Total store operating costs	87.8	% 88.9	% 86.4	% 88.0	%

Table of Contents

Total store operating costs as a percentage of Company-owned store sales decreased 110 basis points in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, due to decreased cost of food and packaging which was partially offset by higher costs in compensation and benefits, occupancy and other store operating costs. For the six months ended June 29, 2015, total store operating costs as a percentage of company-owned store revenues decreased 160 basis points compared to the six months ended June 30, 2014, due to decreased cost of food and packaging which was partially offset by higher costs in compensation and benefits, occupancy and other store operating costs

**Effect of Store Portfolio Changes.** We acquired 43 stores, opened nine new stores, closed two stores and refranchised one store over the last twelve months. This shift in our store portfolio is the primary driver behind the increase in Compensation and benefits and Occupancy as a percentage of Company-owned store sales for the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014, as store sales volumes in the newly constructed and acquired stores are currently lower than the segment's average sales.

**Cost of food and packaging.** Lower cheese prices are positively affecting our Cost of food and packaging in total and as a percentage of Company-owned store sales for the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014. Our average cheese price in the three and six months ended June 29, 2015, declined by 14.8% and 18.0%, respectively, over our average cheese price in the three and six months ended June 30, 2014.

**Other store operating costs.** New store pre-opening costs of \$176,000 and \$246,000 were recognized in Other store operating costs for the three and six months ended June 29, 2015, respectively, compared to \$1,000 and \$11,000 in the three and six months ended June 30, 2014, respectively. Pre-opening costs have historically averaged around \$35,000 per store with the majority of the costs incurred in the two months immediately prior to a new store opening. In 2015 the Company has opened 7 new stores as of June 29, 2015, with more nearing completion. Excluding the impact of pre-opening costs in 2015, Other store operating costs as a percentage of Company-owned store sales would have been 9.3% and 8.6% for the three and six months ended June 29, 2015, respectively.

**Selling, general and administrative.** The following table presents Selling, general and administrative costs for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Selling, general and administrative	\$8,162	\$8,824	(7.5)%	\$15,045	\$17,023	(11.6)%
Percentage of total revenues	28.0%	40.4%		25.8%	36.2%	

Selling, general and administrative costs decreased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, primarily due to lower non-recurring costs from 2014, such as management fees related to an advisory services and monitoring agreement, which terminated at the time of the IPO, stock-based compensation and POS system software licenses sold to franchise owners at cost. For the six months ended June 29, 2015, Selling, general and administrative costs decreased compared to the six months ended June 30, 2014, primarily due to non-recurring costs related to an advisory services and monitoring agreement, including its termination at the time of the IPO, stock-based compensation and other costs incurred in connection with the IPO, and costs related to the resale of POS system licenses to franchise owners at cost in the prior year.

As a percentage of Total revenues, Selling, general and administrative costs decreased in the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014, due mainly to higher company store revenues as a result of the store portfolio changes discussed above and higher franchise royalties. Excluding the revenues and expenses related to the resale of the POS system software licenses sold to franchise owners at cost and the costs incurred in preparation for the IPO, Selling, general and administrative costs as a percent of revenues would have been 27.7% and 25.4% for the three and six months ended June 29, 2015, respectively, compared to the respective three and six months ended June 30, 2014.

Table of Contents

Depreciation and amortization. The following table presents Depreciation and amortization for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Depreciation and amortization	\$2,420	\$1,967	23.0 %	\$4,739	\$3,808	24.4 %
Percentage of total revenues	8.3 %	9.0 %		8.1 %	8.1 %	

Depreciation and amortization increased in the three and six months ended June 29, 2015, due primarily to the amortization of reacquired franchise rights and depreciation associated with increasing company-owned store counts and increased capital expenditures on property and equipment for business technology projects.

Interest expense. The following table presents Interest expense for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Interest expense	\$1,149	\$2,316	(50.4)%	\$2,292	\$5,428	(57.8)%
Percentage of total revenues	3.8 %	10.5 %		3.9 %	11.6 %	

Interest expense decreased in the three and six months ended June 29, 2015, as a result of a reduction in outstanding debt through the application of net proceeds from the IPO in May 2014 and an interest rate reduction achieved concurrently with the IPO and through an August 2014 refinancing.

Loss on early retirement of debt. The Loss on early retirement of debt was a result of prepayment penalties and expenses associated with the \$55.5 million prepayment made in May 2014 using proceeds from the IPO.

Loss on disposal or impairment of investments. The Loss on disposal or impairment of investments for the three and six months ended June 29, 2015, was a result of an impairment recognized on the investment in Project Pie prior to its disposal.

Income Taxes. The following table presents income taxes for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
(Benefit from) provision for income taxes	\$(1,160)	\$(1,112)	4.3 %	\$460	\$(421)	N/M
Percentage of total revenues	(3.9)%	(5.0)%		0.8 %	(0.9)%	
Effective tax rate	37.4 %	40.9 %		41.2 %	34.8 %	

N/M = not meaningful

The (Benefit from) provision for income taxes increased in the three months ended June 29, 2015, due primarily to a change in (Loss) Income Before Income Taxes. For the six months ended June 29, 2015, the provision for income taxes increased due primarily to a change in (Loss) Income Before Income Taxes.

The effective tax rate for the three months ended June 29, 2015, decreased primarily due to discrete adjustments related to share-based compensation. The effective tax rate for the six months ended June 29, 2015, increased primarily due to discrete adjustments related to share-based compensation. Our income taxes have varied from what would be expected through the application of prevailing statutory rates mainly due to the impact of meal and entertainment expenses and share-based compensation expenses.

Table of Contents

## Segment Results

Domestic Franchise. The following table presents Domestic Franchise Total revenues and Operating Income for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Total revenues	\$10,878	\$10,324	5.4 %	\$22,813	\$23,371	(2.4)%
Percentage of total revenues	37.4 %	47.3 %		39.1 %	49.8 %	
Operating Income	4,208	4,234	(0.6)%	10,135	10,228	(0.9)%

Total revenues for the Domestic Franchise segment increased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, due mainly to comparable store sales growth of 4.5%. For the six months ended June 29, 2015, Total revenues for the Domestic Franchise segment decreased compared to the six months ended June 30, 2014, due to lower revenue related to the POS system software licenses of \$1.6 million partially offset by segment comparable store sales growth of 5.0%.

Operating Income for the Domestic Franchise segment decreased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, due to an increase in Selling, general and administrative costs, partially offset by increased Total revenues. For the six months ended June 29, 2015, Operating Income for the Domestic Franchise segment decreased compared to the six months ended June 30, 2014, due to decreased Total revenues, partially offset by an increase in Selling, general and administrative costs.

Domestic Company Stores. The following table presents Domestic Company Stores Total revenues and Operating Income for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Total revenues	\$18,156	\$11,477	58.2 %	\$35,323	\$23,495	50.3 %
Percentage of total revenues	62.3 %	52.5 %		60.6 %	50.0 %	
Operating Income	552	158	249.4 %	1,688	678	149.0 %

Total revenues for the Domestic Company Stores segment increased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, as a result of the acquisition of 43 stores from franchise owners, the opening of nine stores, and segment comparable store sales growth of 4.9% which were partially offset by the closure of two stores. For the six months ended June 29, 2015, Total revenues for the Domestic Company Stores segment increased, compared to the six months ended June 29, 2015, due primarily to the acquisition of 43 stores from franchise owners, the opening of nine stores, and segment comparable store sales growth of 5.6%, which were partially offset by the closure of two stores and the divestiture of one store.

Operating Income for the Domestic Company Stores segment increased in the three months ended June 29, 2015, compared to the three months ended June 30, 2014, as a result of a 4.9% increase in comparable store sales and increased operating margins partially offset by an increase in depreciation and amortization related to Company-owned stores portfolio changes. For the six months ended June 29, 2015, Operating Income for the Domestic Company Stores segment increased, compared to the six months ended June 29, 2015, as a result of a 5.6% increase in comparable store sales and increased operating margins, partially offset by an increase in depreciation and amortization related to Company-owned stores portfolio changes.



Table of Contents

International. The following table presents International Total revenues and Operating Income (Loss) for the periods reported:

(in thousands)	Three Months Ended			Six Months Ended		
	June 29, 2015	June 30, 2014	Change	June 29, 2015	June 30, 2014	Change
Total revenues	\$87	\$45	93.3 %	\$154	\$97	58.8 %
Percentage of total revenues	0.3 %	0.2 %		0.3 %	0.2 %	
Operating Income (Loss)	54	(121 )	N/M	78	(225 )	N/M

N/M = not meaningful

Total revenues for the International segment increased for the three and six months ended June 29, 2015, largely as a result of increased franchised royalties and fees.

Operating Income (Loss) for the International segment increased for the three and six months ended June 29, 2015, compared to the respective three and six months ended June 30, 2014, primarily as a result of increased revenues and lower Selling, general and administrative costs.

#### 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. As a public company, we may also raise additional capital through the sale of equity, but such additional capital may not be available on favorable terms, if at all. As of June 29, 2015, we had negative net working capital of \$6.1 million as a result of the relatively quick sales-to-cash cycle and low levels of inventory required to operate our business.

As of June 29, 2015, we had cash and cash equivalents of \$1.1 million and \$20.0 million of available borrowings under a revolving credit facility, of which \$0.5 million was drawn. As of June 29, 2015, we had \$114.1 million of outstanding indebtedness. Principal payments under our 2014 Credit Facility become due on the last day of each fiscal quarter through the life of the 2014 Credit Facility. 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 June 29, 2015, we were in compliance with all of our covenants and other obligations under our 2014 Credit Facility.

#### Cash Flows

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

(in thousands)	Six Months Ended	
	June 29, 2015	June 30, 2014
Cash flows from operating activities	\$9,730	\$528
Cash flows from investing activities	(12,895 )	(1,640 )
Cash flows from financing activities	(803 )	1,416
Total cash flows	\$(3,968 )	\$304

#### Cash Flows from Operating Activities

Net cash provided by operating activities of \$9.7 million for the six months ended June 29, 2015, resulted primarily from net income of \$0.7 million, adjusted for items such as depreciation and amortization and working capital changes. The \$9.2 million increase over the prior year was primarily driven by the \$1.4 million increase in net income and a net increase of \$4.3 million from changes in operating assets and liabilities compared to the six months ended June 30, 2014.

#### Cash Flows from Investing Activities

Net cash used by investing activities was \$12.9 million in the six months ended June 29, 2015, compared to net cash used of \$1.6 million in the six months ended June 30, 2014. The \$11.3 million change in cash used by investing activities was due



Table of Contents

primarily to an increase of \$9.2 million for the acquisition of stores, \$1.7 million of additional acquisition costs for property, plant, and equipment and a decrease of \$0.9 million received from payments on notes receivable compared to the six months ended June 30, 2014.

Cash Flows from Financing Activities

Net cash used by financing activities was \$0.8 million in the six months ended June 29, 2015, compared to net cash provided of \$1.4 million in the six months ended June 30, 2014. The \$2.2 million decrease compared to the six months ended June 30, 2014 was due to payments on subscriptions receivable of \$1.1 million received in the six months ended June 30, 2014.

Contractual Obligations

In connection with its investment in Project Pie, PPH had committed as of December 29, 2014, to fund, upon demand, up to an additional \$0.5 million prior to December 2016 through the purchase of additional Series A Preferred Units of Project Pie. During the six months ended June 29, 2015, PPH invested the additional \$0.5 million and satisfied its commitment to Project Pie.

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 and share-based compensation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under 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.

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.

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 are choosing to “opt out” of this extended transition period, and as a result, we plan to 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.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Commodity Price Risk

We are exposed to market risks from changes in commodity prices. During the normal course of the year, we enter into national pricing commitments for cheese and other food products that are affected by changes in commodity prices and, as a result, our franchise and Company-owned stores are subject to volatility in food costs. We also maintain relationships with multiple suppliers for certain key products, such as cheese. We do not engage in speculative transactions nor do we hold or issue financial instruments for trading purposes. In instances when we use fixed pricing agreements with our suppliers, these agreements cover our physical commodity needs, are not net-settled and are accounted for as normal purchases.

Interest Rate Risk

We are subject to interest rate risk on indebtedness under our 2014 Credit Facility. Interest rates on loans made under our 2014 Credit Facility are based on LIBOR, and under specified circumstances we may be required by our lenders to enter into interest rate swap arrangements. A hypothetical 1.0% increase or decrease in the interest rate associated with our 2014 Credit Facility would have resulted in a \$1.1 million impact to interest expense on an annualized basis.

Foreign Currency Exchange Rate Risk

Our international franchise owners use the local currency as their functional currency. Royalty payments from our franchise owners in the Middle East are generally remitted to us in U.S. dollars and royalty payments from our Canadian franchise owners are generally remitted to us in Canadian dollars. Because our international activities do not account for a significant portion of our revenues, we believe our exposure to foreign currency risk is minimal.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

We have not engaged an independent registered accounting firm to perform an audit of our internal control over financial reporting as of any balance sheet date or for any period reported in our financial statements. Our independent public registered accounting firm will first be required to attest to the effectiveness of our internal control over financial reporting for our Annual Report on Form 10-K for the first year we are no longer an “emerging growth company.”

This Quarterly Report on Form 10-Q does not include a report of management’s assessment regarding internal control over financial reporting or an attestation report of the Company’s registered public accounting firm due to a transition period established by rules of the SEC for newly public companies.

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, 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”). In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply its judgment in evaluating the benefits of possible controls and procedures relative to their costs.

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 were 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.

Table of Contents

Changes in Internal Control over Financial Reporting

There have been no significant 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.

37

---

Table of Contents

PART II — OTHER INFORMATION

Item 1. Legal Proceedings

We currently are subject to litigation with a group of our franchise owners. In January 2014, six franchise owner groups claimed that we misrepresented our sales volumes, made false representations to them and charged excess advertising fees, among other things. We 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 we were unable to reach a settlement agreement. On April 4, 2014, a total of 12 franchise owner groups, including those franchise owners that previously made the allegations described above, filed a lawsuit against us 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 us 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 us prior to filing the lawsuit must mediate with us 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 us prior to filing the lawsuit, must do so, and that their claims be stayed until they have completed mediating with us in good faith.

In October 2014, we engaged in mediation with the 22 franchise owner groups who had not previously done so. As a result of that mediation and other efforts, we have reached resolution with eleven 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 plaintiffs in the consolidated lawsuits filed an amended complaint, removing some claims, amending some claims, adding claims and naming some of our former and current franchise sales staff as additional individual defendants. We have filed an answer denying the material allegations of the amended complaint. We believe the allegations in these consolidated lawsuits lack merit and, for those plaintiffs with whom we are unable to reach resolution, we will continue to vigorously defend our interests, including by asserting a number of affirmative defenses and, where appropriate, counterclaims. We provide no assurance that we will be successful in our defense of these lawsuits; however, we do not currently expect the cost of resolving them to have a material adverse effect on our consolidated financial position, results of operations, or cash flows.

On May 8, 2015, we were named as a defendant in a class action lawsuit claiming a violation of the Telephone Consumer Protection Act, which prohibits companies from making telemarketing calls to numbers listed in the Federal Do-Not-Call Registry and imposes other obligations and limitation on making phone calls and sending text messages to consumers. The lawsuit alleges that we did not comply with the statutory requirements for obtaining consumers' consent to receive text messages from us, and seeks statutory penalties for those alleged deficiencies. We believe the plaintiff's interpretation of the applicable law is incorrect, and we will vigorously defend ourselves in the lawsuit, but provide no assurance that we will be successful. An adverse judgment or settlement could have an adverse impact on our profitability and could cause variability in our results compared to expectations.

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



Table of Contents

Item 1A. Risk Factors

An investment in our common stock involves a high degree of risk. Before making an investment decision, you should carefully consider the following risk factors, as well as the other information in this Quarterly Report on Form 10-Q. 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 following risk factors and other information included in this Quarterly Report on Form 10-Q include any material changes to and supersede the description of the risk factors associated with our business previously disclosed in our Annual Report on Form 10-K for the year ended December 29, 2014, and should be carefully considered before making an investment decision relating to our common stock.

Risks Related to our Business and Industry

The limited service restaurant pizza category and restaurant sector overall are highly competitive and such competition could adversely affect our business, financial condition and results of operations.

The restaurant industry in general, and the limited service restaurant pizza category in particular, are highly competitive with respect to price, value, food quality, ambience, convenience, concept, service and location. A substantial number of restaurant operations compete with us for customer traffic. We compete against other major national limited service restaurant pizza chains and regional and local businesses, including other chains offering pizza products. We also compete on a broader scale with other international, national, regional and local limited-service restaurants. In addition, we face increasing competition from pizza product offerings available at grocery stores and convenience stores, which offer pre-made ready-to-bake frozen and carry-out pizzas. Many of our competitors have significantly greater financial, marketing, personnel and other resources as well as greater brand recognition than we do and may have lower operating costs, more restaurants, better locations and more effective marketing than we do. Many of our competitors are well established in markets in which we and our franchise owners operate stores or intend to locate new stores. In addition, many of our competitors emphasize lower-cost value options or meal packages or have loyalty programs, which provide discounts on certain menu offerings, and they may continue to do so in the future.

We also compete for employees, suitable real estate sites and qualified franchise owners. If we are unable to compete successfully and maintain or enhance our competitive position, or if customers have a poor experience at a Papa Murphy's store, whether Company-owned or franchise-owned, we could experience decreased customer traffic, downward pressure on prices, lower demand for our products, reduced margins, diminished ability to take advantage of new business opportunities and the loss of market share, all of which could have a material and adverse effect on our business, financial condition and results of operations.

The food service market is affected by consumer preferences and perceptions. Changes in these preferences and perceptions may lessen the demand for our products, which would reduce sales and harm our business.

Food service businesses are affected by changes in consumer tastes, international, national, regional and local economic conditions and demographic trends. For instance, if prevailing health or dietary preferences cause consumers to avoid pizza and other products we offer in favor of foods that are perceived as more healthy, our business, financial condition and results of operations would be materially and adversely affected. In addition, if consumers no longer seek pizza that they can bake at home in favor of pizza that is already baked and/or delivered, our business, financial condition and results of operations would be materially and adversely affected. Moreover, because we are primarily dependent on a single product, if consumer demand for pizza in general, and take and bake pizza in particular, should decrease, our business would be adversely affected more than if we had a more diversified menu, as many other food service businesses do.

Our business and results of operations depend significantly upon the success of our and our franchise owners' existing and new stores.

Our business and results of operations are significantly dependent upon the success of our franchised and Company-owned stores. We and our franchise owners may be adversely affected by:

- declining economic conditions, including downturns in the housing market, increases in unemployment rates, reductions in consumer disposable income, adverse credit market conditions, increases in fuel prices, drops in



consumer confidence and other events or factors that adversely affect consumer spending in the markets that we serve;

Table of Contents

• increased competition in the restaurant industry, particularly in the pizza, casual and fast-casual dining segments;

• changes in consumer tastes and preferences;

• demographic trends;

• customers' budgeting constraints;

• customers' willingness to accept menu price increases that we may make to offset increases in key input and operating costs;

• adverse weather conditions;

• our reputation and consumer perception of our concepts' offerings in terms of quality, price, value, ambiance and service; and

• customers' experiences in our stores.

Our Company-owned stores and our franchise owners are also susceptible to increases in certain key operating expenses that are either wholly or partially beyond our control, including:

• food costs, particularly for mozzarella cheese and other raw materials, many of which we do not or cannot effectively hedge;

• labor costs, including wages, which are effected by minimum wage requirements, workers' compensation, health care and other benefits expenses;

• rent expenses and construction, remodeling, maintenance and other costs under leases for our new and existing stores;

• compliance costs as a result of changes in legal, regulatory or industry standards;

• energy, water and other utility costs;

• insurance costs;

• information technology and other logistics costs; and

• litigation expenses.

If we fail to open new domestic and international franchise and Company-owned stores on a timely basis, our ability to increase our revenues could be materially and adversely affected.

A significant component of our growth strategy includes the opening of new domestic and international franchise stores. We and our franchise owners face many challenges associated with opening new stores, including:

• identification and availability of suitable store locations with the appropriate size, visibility, traffic patterns, local residential neighborhoods, local retail and business attractions and infrastructure that will drive high levels of customer traffic and sales per store;

• competition with other restaurants and retail concepts for potential store sites;

• anticipated commercial, residential and infrastructure development near new or potential stores;

• ability to negotiate acceptable lease arrangements;

• availability of financing and ability to negotiate acceptable financing terms;

• recruiting, hiring and training of qualified personnel;

• construction and development cost management;

• completing our construction activities on a timely basis;

• obtaining all necessary governmental licenses, permits and approvals and complying with local, state and federal laws and regulations to open, construct or remodel and operate our stores;

• unforeseen engineering or environmental problems with the leased premises;

• adverse weather during the construction period of new stores; and

• other unanticipated increases in costs or delays.

As a result of these challenges, we and our franchise owners may not be able to open new stores as quickly as planned or at all. We and our franchise owners have experienced, and expect to continue to experience, delays in store openings from time to time and have abandoned plans to open stores in various markets on occasion. Any delays or failures to open new stores by us or our franchise owners could materially and adversely affect our growth strategy and our results of operations.

Table of Contents

Our progress in opening new stores from quarter to quarter may occur at an uneven rate. If we do not open new stores in the future according to our current plans, the delay could materially and adversely affect our business, financial condition or results of operations.

If we fail to identify, recruit and contract with a sufficient number of qualified franchise owners, our ability to open new franchise stores and increase our revenues could be materially and adversely affected.

The opening of additional franchise stores depends, in part, upon the availability of prospective franchise owners who meet our criteria. Because most of our franchise owners open and operate one or two stores, our growth strategy requires us to identify, recruit and contract with a significant number of new franchise owners each year. We may not be able to identify, recruit or contract with suitable franchise owners in our target markets on a timely basis or at all. In addition, our franchise owners may not have access to the financial or management resources that they need to open the stores contemplated by their agreements with us, or they may elect to cease store development for other reasons. If we are unable to recruit suitable franchise owners or if franchise owners are unable or unwilling to open new stores as planned, our growth may be slower than anticipated, which could materially and adversely affect our ability to increase our revenues and materially and adversely affect our business, financial condition and results of operations. The planned rapid increase in the number of our stores may make our future results unpredictable and, if we fail to manage such growth effectively, our business, financial condition and results of operations may be materially and adversely affected.

Our growth strategy and investment associated with the development of each new store may cause our results to fluctuate and be unpredictable or materially and adversely affect our results of operations. For example, our pre-opening expenses may vary from period to period based on the timing of when we open new company-owned stores, which could impact our results of operations from period to period. In addition, our franchise owners and our ability to successfully develop new stores in new markets may be adversely affected by a lack of awareness or acceptance of our brand and the take and bake concept as well as by a lack of existing marketing efforts and operational execution in these new markets. Stores in new markets may also face challenges related to being new to a market and having less marketing funds than competitors, which may be due in part to lower store density than competitors. To the extent that we are unable to foster name recognition and affinity for our brand and concept in new markets and implement effective advertising and promotional programs, our and our franchise owners' new stores may not perform as expected and our growth may be significantly delayed or impaired. Moreover, as has happened when other store concepts have tried to expand, we may find that our concept has limited appeal in new markets or we may experience a decline in the popularity of our concept in the markets in which we operate. New stores may also have difficulty securing adequate financing, particularly in new markets, where there may be a lack of adequate sales history and brand familiarity. Newly opened stores, including newly opened stores in new markets, may not be successful and our system-wide average store sales may not increase at historical rates, which could materially and adversely affect our business, financial condition or results of operations.

Our existing store management systems, financial and management controls and information systems may be inadequate to support our planned expansion. Managing our growth effectively will require us to continue to enhance these systems, procedures and controls and to hire, train and retain managers and team members. We believe our culture—from the store level up through management—is an important contributor to our success. As we grow, however, we may have difficulty maintaining our culture or adapting it sufficiently to meet the needs of our operations. Among other important factors, our culture depends on our ability to attract, retain and motivate employees who share our enthusiasm and dedication to our concept. We may not respond quickly enough to the changing demands that our expansion will impose on our management, store teams, existing infrastructure and culture, which could materially and adversely affect our business, financial condition or results of operations.

New information or attitudes regarding diet and health could result in changes in regulations and consumer consumption habits that could adversely affect our results of operations.

Government regulation and consumer eating habits may impact our business as a result of changes in attitudes regarding diet and health or new information regarding the adverse health effects of consuming certain menu offerings. These changes have resulted in, and may continue to result in, laws and regulations requiring us to disclose the nutritional content of our food offerings, and they have resulted, and may continue to result in, laws and

regulations affecting permissible ingredients and menu offerings. For example, a number of states, counties and cities have enacted menu labeling laws requiring multi-unit restaurant operators to disclose to consumers certain nutritional information, or have enacted legislation restricting the use of certain types of ingredients in restaurants. These requirements may be different or inconsistent with requirements under the Patient Protection and Affordable Care Act of 2010 ("PPACA"), which establishes a uniform, federal requirement for certain restaurants to post nutritional information on their menus. Specifically, the PPACA requires chain restaurants with 20 or more locations operating under the same

Table of Contents

name and offering substantially the same menus to publish the total number of calories of standard menu items on menus and menu boards, along with a statement that puts this calorie information in the context of a total daily calorie intake. These inconsistencies could be challenging for us to comply with in an efficient manner. The PPACA also requires covered restaurants to provide to consumers, upon request, a written summary of detailed nutritional information for each standard menu item, and to provide a statement on menus and menu boards about the availability of this information upon request. An unfavorable report on, or reaction to, our menu ingredients, the size of our portions or the nutritional content of our menu items could negatively influence the demand for our products and materially and adversely affect our business, financial condition and results of operations.

Compliance with current and future laws and regulations regarding the ingredients and nutritional content of our menu items may be costly and time-consuming. Additionally, if consumer health regulations or consumer eating habits change significantly, we may be required to modify or discontinue certain menu items, and we may experience higher costs associated with the implementation of those changes. We cannot predict the impact of the new nutrition labeling requirements under the PPACA until final regulations are implemented. The risks and costs associated with nutritional disclosures on our menus could also impact our operations, particularly given differences among applicable legal requirements and practices within the restaurant industry with respect to testing and disclosure, ordinary variations in food preparation among our own restaurants, and the need to rely on the accuracy and completeness of nutritional information obtained from third-party suppliers.

Our results of operations and growth strategy depend in significant part on the success of our franchise owners, and we are subject to a variety of additional risks associated with our franchise owners, including litigation that has been brought against us by certain franchise owners.

A substantial portion of our revenues comes from royalties generated by our franchise stores. We anticipate that franchise royalties will represent a substantial part of our revenues in the future. Accordingly, we are reliant on the performance of our franchise owners in successfully opening and operating their stores and paying royalties to us on a timely basis. Our franchise system subjects us to a number of risks, any one of which may impact our ability to collect royalty payments from our franchise owners, may harm the goodwill associated with our brands, and may materially and adversely affect our business and results of operations.

Franchise owner independence. Franchise owners are independent operators, and their employees are not our employees. Accordingly, their actions are outside of our control. Although we have developed criteria to evaluate and screen prospective franchise owners, we cannot be certain that our franchise owners will have the business acumen or financial resources necessary to operate successful franchises in their locations and state franchise laws may limit our ability to terminate or modify these franchise agreements. Moreover, despite our training, support and monitoring, franchise owners may not successfully operate stores in a manner consistent with our standards and requirements, or may not hire and adequately train qualified managers and other store personnel. The failure of our franchise owners to operate their franchises successfully and actions taken by their employees could each have a material and adverse effect on our reputation, brand, ability to attract prospective franchise owners, business, financial condition or results of operations.

Franchise agreement termination or nonrenewal. Each franchise agreement is subject to termination by us as the franchisor in the event of a default, generally after expiration of applicable cure periods, although under certain circumstances a franchise agreement may be terminated by us upon notice without an opportunity to cure. The default provisions under the franchise agreements are drafted broadly and include, among other things, any failure to meet operating standards and actions that may threaten our licensed intellectual property.

In addition, each franchise agreement has an expiration date. Upon the expiration of the franchise agreement, we or the franchise owner may, or may not, elect to renew the franchise agreement. If the franchise agreement is renewed, the franchise owner will receive a successive franchise agreement for an additional term. Such option, however, is contingent on the franchise owner's execution of the then-current form of franchise agreement (which may include increased royalty payments, advertising fees and other costs), the satisfaction of certain conditions (including modernization of the restaurant and related operations) and the payment of a renewal fee. If a franchise owner is unable or unwilling to satisfy any of the foregoing conditions, we may elect not to renew the expiring franchise agreement, in which event the franchise agreement will terminate upon expiration of the term.

Franchise owner insurance. The franchise agreements require each franchise owner to maintain certain insurance types and levels. Certain extraordinary hazards, however, may not be covered, and insurance may not be available (or may be available only at prohibitively expensive rates) with respect to many other risks. Moreover, any loss incurred could exceed policy limits and any policy payments made to franchise owners may not be made on a timely basis. Any such loss or delay in payment could have a material and adverse effect on

Table of Contents

a franchise owner's ability to satisfy obligations under the franchise agreement, including the ability to make royalty payments. Further, the franchise owner may fail to obtain or maintain the required insurance types and levels, and we may not be aware of that failure until a loss is incurred.

Product liability exposure. We require franchise owners to maintain general liability insurance coverage to protect against the risk of product liability and other risks and demand strict franchise owner compliance with health and safety regulations. However, franchise owners may receive or produce defective food or beverage products, which may materially and adversely affect our brand's goodwill and our business. Further, a franchise owner's failure to comply with health and safety regulations, including requirements relating to food quality or preparation, could subject the franchise owner, and possibly us, to litigation. Any litigation, including the imposition of fines or damage awards, could adversely affect the ability of a franchise owner to make royalty payments, or could generate negative publicity, or otherwise adversely affect us.

Franchise owners' participation in our strategy. Our franchise owners are an integral part of our business. We may be unable to successfully implement our growth strategy if our franchise owners do not actively participate in such implementation. From time to time, franchise owners, individually or through the Papa Murphy's Franchise Association (the "PMFA"), which is an independent association of franchise owners, have disagreed with or resisted elements of our strategy, including new product initiatives and investments in their stores such as remodeling and implementing the POS system. Franchise owners may also fail to participate in our marketing initiatives, which could materially and adversely affect their sales trends, average weekly sales ("AWS") and results of operations. In addition, the failure of our franchise owners to focus on the fundamentals of restaurant operations, such as quality, service and cleanliness, would have a negative impact on our success. It also may be difficult for us to monitor our international franchise owners' implementation of our growth strategy due to our lack of personnel in the markets served by such franchise owners.

Franchise owner litigation and conflicts with franchise owners. Franchise owners are subject to a variety of litigation risks, including customer claims, personal-injury claims, environmental claims, employee allegations of improper termination and discrimination, intellectual property claims and claims related to violations of the ADA, religious freedom, the FLSA, the Employee Retirement Income Security Act of 1974, as amended, and advertising laws. Each of these claims may increase costs and limit the funds available to make royalty payments and reduce entries into new franchise agreements. We also may be named in lawsuits against our franchise owners.

In addition, the nature of the franchisor-franchise owner relationship may give rise to conflict. For example, the PMFA has expressed a number of concerns and disagreements that the franchise owners it represents has or has had with our Company, including concern over a lack of franchise owner involvement in strategic decision-making, inadequate assistance in increasing and difficulty maintaining franchise store profitability in a higher cost environment, disagreement with marketing initiatives and product launches, and dissatisfaction with costs associated with the new store remodel program and with the implementation of a new POS system. Our senior management team has engaged with franchise owner leadership to address these concerns and resolve specific issues raised by the franchise owners. Such engagement may not result in a satisfactory resolution of the issues, which, in turn, could materially and adversely affect our ability to grow our franchise system and maintain relationships with our franchise owners, damage our reputation and our brand, and materially and adversely affect our results of operations.

We currently are subject to litigation with a group of our franchise owners as described in Part II, Item 1, Legal Proceedings above. We also may become subject to additional litigation with franchise owners in the future. Engaging in such litigation may be costly, time-consuming and distracting to management and also may materially and adversely affect our relationships with potential franchise owners and our ability to attract new franchise owners. In addition to these and other claims that may be brought against us by franchise owners, we also may engage in future litigation with franchise owners to enforce the terms of our franchise agreements and compliance with our brand standards as determined necessary to protect our brand, the consistency of our products and the customer experience. Such litigation may be time consuming and costly. Any negative outcome of these or any other claims could materially and adversely affect our results of operations as well as our ability to expand our franchise system and may damage our reputation and our brand.

-

Americans with Disabilities Act. Restaurants located in the United States must comply with Title III of the ADA. Although we believe newer restaurants meet the ADA construction standards and, further, that franchise owners have historically been diligent in the remodeling of older restaurants, a finding of noncompliance with the ADA could result in the imposition of injunctive relief, fines, awards of damages to private litigants or additional capital expenditures to remedy such noncompliance. Any imposition of injunctive relief, fines, damage



Table of Contents

awards or capital expenditures could adversely affect the ability of a franchise owner to make royalty payments, or could generate negative publicity, or otherwise adversely affect us.

Access to credit. Our franchise owners typically finance new operations and new store openings with loans or other forms of credit. If our franchise owners are unable to access credit or obtain sufficient credit, if interest rates on loans that our franchise owners use to finance operations of current stores or to open new stores increase or if franchise owners are unable to service their debt, our franchise owners may have difficulty operating their stores or opening new stores, which could materially and adversely affect our results of operations as well as our ability to expand our franchise system.

Franchise owner bankruptcy. The bankruptcy of a multi-unit franchise owner could negatively impact our ability to collect payments due under such franchise owner's franchise agreement. In a franchise owner bankruptcy, the bankruptcy trustee may reject its franchise agreements pursuant to Section 365 under the United States bankruptcy code, in which case there would be no further royalty payments from such franchise owner. There is no assurance as to the proceeds, if any, that may ultimately be recovered in a bankruptcy proceeding of such franchise owner in connection with a damage claim resulting from such rejection.

Opening new stores in existing markets may negatively affect sales at existing stores.

We intend to continue opening new franchise stores in our existing markets as a core part of our growth strategy.

Expansion in existing markets may be affected by local economic and market conditions. Further, the customer target area of our stores varies by location, depending on a number of factors, including population density, other local retail and business attractions, area demographics and geography. As a result, the opening of a new store in or near markets in which stores already exist could adversely affect the sales of these existing stores. We and our franchise owners may selectively open new stores in and around areas of existing stores. Competition for sales between our stores may become significant in the future as we continue to expand our operations and could affect sales growth, which could, in turn, materially and adversely affect our business, financial condition or results of operations.

New stores may not be profitable and the increases in AWS and comparable store sales that we have experienced in the past may not be indicative of future results.

New stores may not be profitable and their sales performance may not follow historical patterns. In addition, our AWS and comparable store sales may not increase at the rates achieved over the past several years. AWS for new domestic stores can be influenced by a number of factors, including the mix of new stores opening in core, developing, and new markets or in high-AWS and low-AWS markets. Other factors that may impact AWS, comparable store sales, and performance of new stores are the level of media efficiency, pricing structure, the competitive activity in any market, our overall marketing plans, the timing of new store openings, and franchise owner experience and ability. In addition, our store grand opening plan focuses less on driving opening day sales as it does on delivering a more sustainable sales level and extending sales momentum well into the first full fiscal year of operations. Although this plan may allow for steadier and more sustainable growth, it may also result in lower AWS in earlier periods. Profits and sales performance for new stores in newer, less-penetrated markets may further be adversely affected by a lack of awareness or acceptance of our brand and concept as well as by a lack of existing marketing efforts and operational execution in these markets.

If new stores do not perform as planned, or if we or our franchise owners are unable to achieve our expected AWS for the new stores, our business, financial condition or results of operations could be materially and adversely affected.

Our expansion into international markets exposes us to a number of risks that may differ in each country where we have franchise stores.

We currently have franchise stores in Canada and the United Arab Emirates and plan to continue to grow internationally. Our international operations are in early stages and historically have not been profitable and have achieved lower margins than our domestic stores. We expect this financial performance to continue in the near-term. Expansion in international markets may also be affected by local economic and market conditions. Therefore, as we expand internationally, our franchise owners may not experience the operating margins we expect, and our results of operations and growth may be materially and adversely affected. Our financial condition and results of operations may be adversely affected if global markets in which our franchise stores compete are affected by changes in political, economic or other factors. These factors, over which neither our franchise owners nor we have control, may include:

- recessionary or expansive trends in international markets;
- changing labor conditions and difficulties in staffing and managing our foreign operations;
- increases in the taxes we pay and other changes in applicable tax laws;
- legal and regulatory changes, and the burdens and costs of our compliance with a variety of foreign laws;

Table of Contents

• changes in inflation rates;  
• changes in exchange rates and the imposition of restrictions on currency conversion or the transfer of funds;  
• difficulty in protecting our brand, reputation and intellectual property;  
• difficulty in collecting our royalties and longer payment cycles;  
• expropriation of private enterprises;  
• increases in anti-American sentiment and the identification of the Papa Murphy's brand as an American brand;  
• political and economic instability; and  
• other external factors.

Termination of area development agreements ("ADAs") or master franchise agreements with certain franchise owners could adversely impact our revenues.

We enter into ADAs with certain domestic franchise owners that plan to open multiple Papa Murphy's stores in a designated market area and we have entered into master franchise agreements with third-parties to develop and operate stores in Canada and in the Middle East. These franchise owners are granted certain rights with respect to specified territories, and at their discretion, these franchise owners may open more stores than specified in their agreements. The termination of ADAs or other arrangements with a master franchise owner or a lack of expansion by these franchise owners could result in the delay of the development of franchised restaurants or discontinuation or an interruption in the operation of our brands in a particular market or markets. We may not be able to find another operator to resume development activities in such market or markets. Any such delay, discontinuation or interruption would result in a delay in, or loss of, royalty income to us by way of reduced sales and could materially and adversely affect our business, financial condition or results of operations.

We are subject to all of the risks associated with leasing space subject to long-term non-cancelable leases.

We do not own any of the real property where our Company-owned stores operate. Payments under our operating leases account for a portion of our operating expenses, and we expect to lease the real property where any of the new Company-owned stores we may open in the future will operate. Our leases generally have an initial term of five years and generally can be extended only in five-year increments (at increased rates). All of our leases require a fixed annual rent, although some require the payment of additional rent if store sales exceed a negotiated amount. Generally, our leases are net leases, which require us to pay all of the cost of insurance, taxes, maintenance and utilities. We generally cannot cancel these leases. Additional sites that we lease are likely to be subject to similar long-term non-cancelable leases. Additionally, we may sublease or assign leases to our franchisees, either before or after we have developed a store at the leased location. When we assign or sublease our leases to franchisees, we will in most instances be required to retain ultimate liability to the landlord. If an existing or future store is not profitable, resulting in its closure, or if, in the case of a lease that we have subleased or assigned to a franchisee, the franchisee defaults on the subleased or assigned lease, we could lose some or all of our development investment as well as be committed to perform our obligations under the applicable lease including, among other things, paying the base rent for the balance of the lease term. We may also be subject to a claim by the defaulting franchisee that we knew or should have known that the leased location would be unprofitable.

In addition, we may fail to negotiate renewals as each of our leases expires, either on commercially acceptable terms or at all, which could cause us to pay increased occupancy costs or to close stores in desirable locations. These potential increased occupancy costs and closed stores could materially and adversely affect our business, financial condition or results of operations.

The impact of negative economic factors, including the availability of credit, on our and our franchise owners' landlords could negatively affect our results of operations.

Negative effects on our and our franchise owners' existing and potential landlords due to the inaccessibility of credit and other unfavorable economic factors may, in turn, adversely affect our business and results of operations. If our or our franchise owners' landlords are unable to obtain financing or remain in good standing under their existing financing arrangements, they may be unable to provide construction funding to us or satisfy other lease covenants. In addition, if our franchise owners or our landlords are unable to obtain sufficient credit to continue to properly manage their retail sites, we may experience a drop in the level of quality of such retail locations. The development of new stores may also be adversely affected by the negative financial situations of developers and potential landlords.

Landlords may try to delay or cancel development projects (as well as renovations of existing projects) if there is instability in the credit markets or declines in consumer spending, which could reduce the number of appropriate locations available that we would consider for our new stores. Furthermore, the failure of landlords to obtain licenses or permits for development

45

---

Table of Contents

projects on a timely basis, which is beyond our control, may negatively impact our ability to implement our development plan.

Damage to our reputation and the Papa Murphy's brand and negative publicity relating to our stores, including our franchise stores, could reduce sales at some or all of our other stores and could negatively impact our business, financial condition and results of operations.

Our success is dependent in part upon our ability to maintain and enhance the value of the Papa Murphy's brand, consumers' connection to our brand and positive relationships with our franchise owners. We may, from time to time, be faced with negative publicity relating to food quality, store facilities, customer complaints or litigation alleging illness or injury, health inspection scores, integrity of our or our suppliers' food processing, employee and franchise owner relationships, franchise owner litigation or other matters, regardless of whether the allegations are valid or whether we are held to be responsible. The risks associated with such negative publicity cannot be completely eliminated or mitigated and may materially and adversely affect our business, financial condition and results of operations and result in damage to our brand. For multi-location food service businesses such as ours, the negative impact of adverse publicity relating to one store or a limited number of stores may extend far beyond the stores or franchise owners involved to affect some or all of our other stores. The risk of negative publicity is particularly great with respect to our franchise stores because we are limited in the manner in which we can regulate them, especially on a real-time basis. A similar risk exists with respect to unrelated food service businesses, if consumers associate those businesses with our own operations.

The use of social media platforms and similar devices, including weblogs (blogs), social media websites and other forms of Internet-based communications which allow individuals to access a broad audience of consumers and other interested persons has increased markedly. Consumers value readily available information concerning goods and services that they purchase and may act on such information without further investigation or authentication. The availability of information on social media platforms is virtually immediate, as is its impact. Many social media platforms immediately publish the content their subscribers and participants post, often without filters or checks on accuracy of the content posted. The opportunity for dissemination of information, including inaccurate information, is seemingly limitless and readily available. Information concerning our Company may be posted on such platforms at any time. Information posted may be adverse to our interests or may be inaccurate, each of which may harm our performance, prospects or business. The harm may be immediate without affording us an opportunity for redress or correction. Such platforms also could be used for dissemination of trade secret information, compromising valuable Company assets. In general, the dissemination of information online could materially and adversely affect our business, financial condition and results of operations, regardless of the information's accuracy.

Our success depends in part upon effective advertising and marketing campaigns, which may not be successful, and franchise owner support of such advertising and marketing campaigns, as well as compliance with the restrictions and obligations imposed by laws regulating certain marketing practices.

We believe the Papa Murphy's brand is critical to our business. We expend resources in our marketing efforts using a variety of media, including social media, email and opt-in text messaging. We expect to continue to conduct brand awareness programs and customer initiatives to attract and retain customers. Additionally, some of our competitors have greater financial resources than we do, which enables them to spend significantly more on marketing and advertising than us. Should our competitors increase spending on marketing and advertising, or should our advertising and promotions be less effective than our competitors, our business, financial condition and results of operations could be materially and adversely affected.

The support of our franchise owners is critical for the success of our advertising and the marketing campaigns we seek to undertake, and the successful execution of these campaigns will depend on our ability to maintain alignment with our franchise owners. Our franchise owners are required to spend approximately five percent of net sales directly on local advertising or contribute to a local fund managed by franchise owners in certain market areas to fund the purchase of advertising media. Our franchise owners are also required to contribute two percent of their net sales to a national fund to support the development of new products, brand development and national marketing programs. In addition, we, our franchise owners and other third-parties may contribute additional advertising funds, and have done so at various times. Although we maintain control over advertising and marketing materials and can mandate certain

strategic initiatives pursuant to our franchise agreements, we need the active support of our franchise owners if the implementation of these initiatives is to be successful. Additional advertising funds are not contractually required, and we, our franchise owners and other third-parties may choose to discontinue contributing additional funds in the future. Any significant decreases in our advertising and marketing funds or financial support for advertising activities could significantly curtail our marketing efforts, which may in turn materially and adversely affect our business, financial condition and results of operations.

Table of Contents

Further, some of our marketing campaigns involve emails and opt-in text messages. In the United States, the Telephone Consumer Protection Act imposes obligations and limitations on making phone calls and sending text messages to consumers. The Federal Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 (the “CAN-SPAM Act”) regulates commercial email messages and specifies penalties for the transmission of commercial email messages that do not comply with certain requirements, such as providing an opt-out mechanism for stopping future emails from senders. States and other countries have similar laws related to telemarketing and commercial emails. Additional or modified laws and regulations, or interpretations of existing, modified or new laws, regulations and rules, could prohibit or increase the cost of engaging with consumers and impair our ability to expand the use of our marketing techniques to more customers. Failure to comply with obligations and restrictions related to text message and email marketing could subject us to lawsuits, fines, statutory damages, consent decrees, injunctions, adverse publicity and other losses that could harm our business.

Our sales and profits could be adversely affected if comparable store sales are less than we expect.

The level of comparable store sales, which represent the change in year-over-year sales for stores open for at least 52 full weeks from the comparable date (the Tuesday following the opening date), will affect our sales growth and will continue to be a critical factor affecting our profits because the profit margin on comparable store sales is generally higher than the profit margin on new store sales. Our franchise owners’ and our ability to increase comparable store sales depends in part on our ability to successfully implement our initiatives to build sales. It is possible such initiatives will not be successful, that we will not achieve our target comparable store sales growth or that the change in comparable store sales could be negative, which may cause a decrease in sales and our profits that would materially and adversely affect our business, financial condition or results of operations.

We experience the effects of seasonality.

Seasonal factors and the timing of holidays cause our revenues to fluctuate from quarter to quarter. We typically follow family eating patterns at home, with our strongest sales levels occurring in the months of September through May, and our lowest sales levels occurring in the months of June, July and August. Therefore, our revenues per store are typically higher in the first and fourth quarters and lower in the second and third quarters. Additionally, our new store openings have historically been concentrated in the fourth and first quarters because new franchise owners may seek to benefit from historically stronger sales levels occurring in these periods. We believe that new store openings will continue to be weighted towards the fourth quarter. As a result of these factors, our quarterly and annual results of operations and comparable store sales may fluctuate significantly. Accordingly, results for any one quarter are not necessarily indicative of results to be expected for any other quarter or for any year and comparable store sales for any particular future period may decrease and materially and adversely affect our business, financial condition or results of operations.

Changes in economic conditions, including effects from recession, adverse weather and other unforeseen conditions, could materially and adversely affect our business, financial condition and results of operations.

The restaurant industry depends on consumer discretionary spending. Economic conditions may remain volatile and may depress consumer confidence and discretionary spending in the near term. If the economy fails to fully recover for a prolonged period of time or worsens and if our customers have less discretionary income or reduce the amount they spend on quick service meals, customer traffic could be adversely impacted. We believe that if negative economic conditions persist for a long period of time or become pervasive, consumers might make long-lasting changes to their discretionary spending behavior, including dining out less frequently. In addition, given our geographic concentrations in the West and Midwest, economic conditions in these particular areas of the country could have a disproportionate impact on our overall results of operations, and regional occurrences such as local strikes, terrorist attacks, increases in energy prices, adverse weather conditions, tornadoes, earthquakes, hurricanes, floods, droughts, fires or other natural or man-made disasters could materially and adversely affect our business, financial condition and results of operations. Adverse weather conditions may also impact customer traffic at our stores, and, in more severe cases, cause temporary store closures, sometimes for prolonged periods. If store sales decrease, our profitability could decline as we spread fixed costs across a lower level of sales. Reductions in staff levels, asset impairment charges and potential store closures could result from prolonged negative store sales. There is no assurance that the macroeconomic environment or the regional economies in which we operate will improve

significantly or that government stimulus efforts will improve consumer confidence, liquidity, credit markets, home values or unemployment, among other things.

Food safety and foodborne illness concerns could have an adverse effect on our business.

We cannot guarantee that our supply chain and food safety controls and training will be fully effective in preventing all food safety issues at our stores, including any occurrences of foodborne illnesses such as salmonella, E. coli and hepatitis A. In addition, we do not assure you that our franchise locations will maintain the high levels of internal controls and training we require at our Company-owned stores. Furthermore, our franchise owners and we rely on third-party vendors, making it difficult to monitor food safety compliance and increasing the risk that foodborne illness would affect



Table of Contents

multiple locations rather than a single store. Some foodborne illness incidents could be caused by third-party vendors and transporters outside of our control. New illnesses resistant to our current precautions may develop in the future, or diseases with long incubation periods could arise, that could give rise to claims or allegations on a retroactive basis. One or more instances of foodborne illness in any of our stores or markets or related to types of food products we sell, if highly publicized on national media outlets or through social media, could negatively affect our store sales nationwide. This risk exists even if it were later determined that the illness was wrongly attributed to us or one of our stores. A number of other restaurant chains have experienced incidents related to foodborne illnesses that have had a material and adverse effect on their operations. The occurrence of a similar incident at one or more of our stores, or negative publicity or public speculation about an incident, could materially and adversely affect our business, financial condition or results of operations.

Changes in food availability and costs could adversely affect our results of operations.

Our profitability and operating margins are dependent in part on our ability to anticipate and react to changes in food costs, particularly the costs of mozzarella cheese and flour. We are party to national supply agreements for core ingredients with certain key third-party suppliers, including Saputo Cheese Inc. and Davisco Foods, for cheese; Pizza Blends, Inc., for flour and dough mix; Neil Jones Foods Company, for tomatoes used in sauce; and several suppliers for meat, pursuant to which we lock in pricing for our franchise owners and Company-owned stores. We rely on Sysco Corporation as the primary distributor of food and other products to our franchise owners and Company-owned stores. Our pricing arrangements with national suppliers typically have terms from three months to a year, after which the pricing may be renegotiated. Each store purchases food supplies directly from these suppliers and produce locally through a produce buying group.

The type, variety, quality, availability and price of produce, meat and cheese are volatile and are subject to factors beyond our control, including weather, governmental regulation, availability and seasonality, each of which may affect our and our franchise owners' food costs or cause a disruption in our supply. For example, cheese pricing is higher in the summer months due to a drop off in milk production in higher temperatures. Our food distributors and suppliers also may be affected by higher costs to produce and transport commodities used in our stores, higher minimum wage and benefit costs and other expenses that they pass through to their customers, which could result in higher costs for goods and services supplied to us. We may not be able to anticipate and react to changing food costs through our purchasing practices and menu price adjustments in the future. As a result, any increase in the prices charged by suppliers would increase the food costs for our Company-owned stores and for our franchise owners and could adversely impact their profitability. In addition, because we provide moderately priced food, we may choose not to, or may be unable to, pass along commodity price increases to consumers, and any price increases that are passed along to consumers may materially and adversely affect store sales which would lower revenues generated from Company-owned stores and franchise owner royalties. These potential changes in food and supply costs and availability could materially and adversely affect our business, financial condition or results of operations.

Our dependence on a sole supplier or a limited number of suppliers for some ingredients could result in disruptions to our business.

Sysco Corporation is the primary distributor of our food and other products to our domestic franchise owners and Company-owned stores and any disruption to this distribution due to work stoppages, strikes or other business interruption may materially and adversely affect our franchise owners and us. The initial term of our Distribution Service Agreement with Sysco expired in August 2007, and now the agreement automatically renews for one-year terms until terminated by either party with written notice one year before the termination date in such notice.

Additionally, we do not have formal long-term arrangements with all of our suppliers, and therefore our suppliers may implement significant price increases or may not meet our requirements in a timely fashion, or at all. Any material interruptions in our supply chain, such as a material interruption of ingredient supply due to the failures of third-party distributors or suppliers, or interruptions in service by common carriers that ship goods within our distribution channels, may result in significant cost increases and reduce store sales. We may not be able to find alternative distributors or suppliers on a timely basis or at all. Our Company-owned and franchise stores could also be harmed by any prolonged disruption in the supply of products from or to our key suppliers due to weather, crop disease and other events beyond our control. Insolvency of key suppliers could also negatively impact our business. Our focus on a

limited menu would make the consequences of a shortage of a key ingredient, such as cheese or flour, more severe, and affected stores could experience significant reductions in sales during the shortage.

Changes in laws related to electronic benefit transfer (“EBT”) systems, could adversely impact our results of operations. Because our products are not cooked, we and our franchise owners currently are able to accept EBT payments, or food stamps, at stores in the United States. Changes in state and federal laws governing where EBT cards may be used and

Table of Contents

what they may be used for may limit our ability to accept such payments and could significantly reduce sales. Reductions in food stamp benefits occurred in November 2013, and further additional reductions in food stamp benefits have been proposed separately by lawmakers in the U.S. Senate and House of Representatives. The recent reductions and potential future reductions in food stamp benefits may reduce sales, which could materially and adversely affect our business, financial condition and results of operations.

Changes in employment laws may adversely affect our business.

Various federal and state labor laws govern our relationships with our employees and the relationships of our franchise owners with their employees, which may impact our and our franchise owners' operating costs. These laws include employee classification as exempt/non-exempt for overtime and other purposes, minimum wage requirements, unemployment tax rates, mandatory health benefits, workers' compensation rates, immigration status, tax reporting and other wage and benefit requirements. A substantial number of employees at our Company-owned and franchise stores are paid at rates related to the U.S. federal minimum wage, and increases in the U.S. federal minimum wage may increase labor costs. Any such increases in labor costs might result in franchise owners inadequately staffing restaurants. Understaffed restaurants could reduce sales at such restaurants, decrease royalty payments and adversely affect our brands.

Various states are considering or have already adopted new immigration laws or enforcement programs. The U.S. Congress and Department of Homeland Security from time to time also consider and may implement changes to federal immigration laws, regulations or enforcement programs. Some of these changes may increase obligations for compliance and oversight, which could subject us to additional costs and make the hiring process for us and our franchise owners more cumbersome, or reduce the availability of potential employees. Although we require all of our employees, including at our Company-owned stores, to provide us with government-specified documentation evidencing their employment eligibility, some of our employees may, without our knowledge, be unauthorized workers. We currently participate in the "E-Verify" program, an Internet-based, free program run by the United States government to verify employment eligibility, in states in which participation is required, and we plan to introduce its use throughout our stores. However, use of the "E-Verify" program does not guarantee that we will properly identify all applicants who are ineligible for employment. In addition, our franchise owners are responsible for screening any employees they hire. Unauthorized workers are subject to deportation and may subject us or our franchise owners to fines or penalties, and if any of our or our franchise owners' workers are found to be unauthorized it may become more difficult for us to hire and keep qualified employees. Termination of a significant number of employees who were unauthorized employees may disrupt store operations and cause temporary increases in our or our franchise owners' labor costs as we train new employees. We could also become subject to fines, penalties and other costs related to claims that we did not fully comply with all recordkeeping obligations of federal and state immigration compliance laws. These factors could materially and adversely affect our business, financial condition or results of operations. In what may signal a trend and change in employment law, franchisors are increasingly subject to claims that they are co-employers with their franchisees, and there seems to be support for such claims within the National Labor Relations Board ("NLRB"), based on recent NLRB decisions. This could expose franchisors, including us, to liability for claims by, or based on the acts of, franchisees' employees. Although we carry insurance policies for a significant portion of our risks and associated liabilities with respect to workers' compensation, general liability, employer's liability, health benefits and other insurable risks, a claim not covered by that insurance, or a judgment in excess of our insurance coverage, could materially and adversely affect our business, financial condition and results of operations. Regardless of whether any claims that may be brought against us are valid or whether we are ultimately determined to be liable, our business, financial condition and results of operations could also be adversely affected by negative publicity, litigation costs resulting from the defense of these claims, and the diversion of time and resources from our operations.

If our franchise owners or we face labor shortages, labor disputes or increased labor costs, our growth and operating results could be adversely affected.

Labor is a primary component in the cost of operating our Company-owned stores and for franchise owners. If we or our franchise owners face labor shortages or increased labor costs because of increased competition for employees, higher employee turnover rates, increases in the federal, state or local minimum wage or other employee benefits costs

(including costs associated with health insurance coverage), our operating expenses could increase and our growth could be adversely affected. In addition, our success depends in part upon our franchise owners' and our ability to attract, motivate and retain a sufficient number of well-qualified store operators and management personnel, as well as a sufficient number of other qualified employees, to keep pace with our expansion schedule. Qualified individuals needed to fill these positions are in short supply in some geographic areas. In addition, restaurants have traditionally experienced relatively high employee turnover rates. Although we have not yet experienced significant problems in recruiting or retaining employees, our franchise owners' and our ability to recruit and retain such individuals may delay

Table of Contents

the planned openings of new stores or result in higher employee turnover in existing stores, which could have a material and adverse effect on our business, financial condition or results of operations.

Additionally, while we do not currently have any unionized employees and are not currently subject to any unionization efforts, there is a potential for union organizers to engage in efforts to organize our employees or those of our franchise owners. Potential union representation and collective bargaining agreements may result in increased labor costs that can have an impact on competitiveness, as well as impact our ability to retain well-qualified employees. Labor disputes, as well, may precipitate strikes and picketing that may have an impact on business, including guest patronage. Further, potential changes in labor laws could increase the likelihood of some or all of our employees being subjected to greater organized labor influence, and could have a material and adverse effect on our business, financial condition or results of operations by imposing requirements that could potentially increase our costs, reduce our flexibility and impact our employee culture.

Any increase in the cost of labor could adversely affect our business and our growth. Competition for employees could require us or our franchise owners to pay higher wages, which could result in higher labor costs. In addition increases in the minimum wage would increase our labor costs. Moreover, costs associated with workers' compensation are rising, and these costs may continue to rise in the future. We may be unable to increase our menu prices in order to pass these increased labor costs on to consumers, in which case our margins would be negatively affected, which could materially and adversely affect our business, financial condition or results of operations.

We invest in developing new product offerings, some of which may not be successful.

We invest in continually developing new potential product offerings as well as in the marketing and advertising of our new products. For example, we recently tested and rolled out nationally Fresh Pan pizza, which is marketed at a price above our regular menu items. Our new product offerings may not be well-received by consumers and may not be successful, which could materially and adversely affect our results of operations.

From time to time we may invest in enhancements to our franchise platform, on which we may not see a return.

We may not see a return on investments we make in our franchise platform. For example, we have invested in a POS system that we continue to implement across our franchise base in order to better manage our business. As part of this investment, in September 2013 we purchased approximately \$4.5 million of POS system software licenses, and we are selling these licenses directly to our franchise owners. We may not be able to sell these licenses to our existing franchise owners on a timely basis, or at all. Our failure to capitalize on investments may materially and adversely affect our financial condition.

The effect of changes to healthcare laws in the United States may increase the number of employees who choose to participate in our healthcare plans, which may significantly increase our healthcare costs and negatively impact our results of operations and our franchise owners.

In 2010, the PPACA was signed into law in the United States to require health care coverage for many uninsured individuals and expand coverage for those already insured. We offer and subsidize comprehensive healthcare coverage, primarily for our salaried employees. The healthcare reform law requires us to offer healthcare benefits to all full-time employees (including full-time hourly employees) that meet certain minimum requirements of coverage and affordability, or face penalties. We offer hourly employees who qualify as full-time employees under the PPACA the option of enrolling in our health care coverage during our annual open enrollment period, but the number of such employees electing to so enroll for the 2014-2015 plan year is low. If the number of full-time hourly employees electing to enroll in our health care coverage increases significantly, we may incur substantial additional expense, or, if the benefits we offer do not meet applicable requirements, we may incur penalties. As of January 1, 2014, the healthcare reform law requires individuals to obtain coverage or face individual penalties on their 2014 tax filing. As a result of the penalty being applied to employees' 2014 tax filings, more full-time employees may elect to participate in our company health coverage to avoid penalties in 2015 and future years, which could also result in our incurring substantial additional expense to pay for the health care coverage of these employees. It is also possible that by making changes or failing to make changes in the healthcare plans offered by us, we will become less competitive in the market for our labor. Finally, implementing the requirements of healthcare reform is likely to impose additional administrative costs. The costs and other effects of these new healthcare requirements are still being determined, but they may significantly increase our healthcare coverage costs and could materially and adversely affect our business,

financial condition or results of operations.

50

---

Table of Contents

Restaurant companies have been the target of class actions and other litigation alleging, among other things, violations of federal and state law. We could be party to litigation that could adversely affect us by distracting management, increasing our expenses or subjecting us to material money damages and other remedies.

We are subject to lawsuits, administrative proceedings and claims that arise in the ordinary course of our business. In recent years, a number of restaurant companies have been subject to claims by customers, employees, franchise owners and others regarding issues such as food safety, personal injury and premises liability, employment-related claims, harassment, discrimination, disability, compliance with advertising laws (including the Telephone Consumer Protection Act) and other operational issues common to the foodservice industry. A number of these lawsuits have resulted in the payment of substantial damages by the defendants. On May 8, 2015, we were named as a defendant in a class action lawsuit claiming a violation of the Telephone Consumer Protection Act, which prohibits companies from making telemarketing calls to numbers listed in the Federal Do-Not-Call Registry and imposes other obligations and limitation on making phone calls and sending text messages to consumers. We believe the plaintiff's interpretation of the applicable law is incorrect and we will vigorously defend ourselves in the lawsuit, but provide no assurance that we will be successful. An adverse judgment or settlement, related to this or any other litigation claim, that is not insured or is in excess of insurance coverage could have an adverse impact on our profitability and could cause variability in our results compared to expectations. We carry insurance policies for a significant portion of our risks and associated liabilities with respect to workers' compensation, general liability, employer's liability, health benefits and other insurable risks. A judgment in excess of our insurance coverage for any claims could materially and adversely affect our business, financial condition and results of operations. Regardless of whether any claims that may be brought against us are valid or whether we are ultimately determined to be liable, our business, financial condition and results of operations could also be adversely affected by negative publicity, litigation costs resulting from the defense of these claims, and the diversion of time and resources from our operations.

Although we have historically experienced very few customer lawsuits, our customers occasionally allege we caused an illness or injury they suffered at or after a visit to our stores, or that we have problems with food quality or operations. We are also subject to a variety of other claims arising in the ordinary course of our business, including personal injury claims, contract claims and claims alleging violations of federal and state law regarding workplace and employment matters, equal opportunity, discrimination and similar matters and may become subject to class action or other lawsuits related to these or different matters in the future. We may also be named as a defendant in any such claims brought against any of our franchise owners. Regardless of whether any claims against us are valid, or whether we are ultimately held liable, claims may be expensive to defend and may divert time and money away from our operations and hurt our performance. A judgment in excess or outside of our insurance coverage for any claims could materially and adversely affect our financial condition or results of operations.

In addition, the restaurant industry has been subject to a growing number of claims based on the nutritional content of food products sold and disclosure and advertising practices. We may also be subject to this type of proceeding in the future and, even if we are not, publicity about these matters (particularly directed at the limited service or fast casual segments of the industry) may harm our reputation and could materially and adversely affect our business, financial condition or results of operations.

Our business operations and future development could be significantly disrupted if we lose key members of our management team.

The success of our business continues to depend, to a significant degree, upon the continued contributions of our senior officers and key employees, both individually and as a group. Our future performance will be substantially dependent in particular on our ability to retain and motivate these senior officers and key employees. Although we have employment agreements in place with certain senior officers and key employees, we cannot prevent them from terminating their employment with us. The loss of the services of our Chief Executive Officer, Chief Financial Officer, other senior officers or other key employees could materially and adversely affect our business and plans for future development. We do not believe that we will lose the services of any of our current senior officers and key employees in the foreseeable future; however, we currently have no effective replacement for any of these individuals due to their experience, reputation in the industry and special role in our operations. We do not maintain any key man life insurance policies for any of our employees.

Our indebtedness may limit our ability to invest in the ongoing needs of our business and if we are unable to comply with our financial covenants, our liquidity and results of operations could be adversely affected. As of June 29, 2015, we had \$114.1 million of outstanding indebtedness, including \$111.1 million of