

PAPA JOHNS INTERNATIONAL INC

Form 10-Q

November 01, 2016

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 September 25, 2016

OR

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number: 0-21660

PAPA JOHN'S INTERNATIONAL, INC.

Edgar Filing: PAPA JOHNS INTERNATIONAL INC - Form 10-Q

(Exact name of registrant as specified in its charter)

Delaware	61-1203323
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification number)

2002 Papa Johns Boulevard

Louisville, Kentucky 40299-2367

(Address of principal executive offices)

(502) 261-7272

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days: Yes 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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer	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 October 25, 2016, there were outstanding 36,889,475 shares of the registrant's common stock, par value \$0.01 per share.

---

Table of Contents

INDEX

	Page No.
<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<b><u>Item 1. Financial Statements</u></b>	
<u>Condensed Consolidated Balance Sheets — September 25, 2016 and December 27, 2015</u>	3
<u>Condensed Consolidated Statements of Income — Three and Nine months ended September 25, 2016 and September 27, 2015</u>	4
<u>Consolidated Statements of Comprehensive Income — Three and Nine months ended September 25, 2016 and September 27, 2015</u>	5
<u>Consolidated Statements of Cash Flows — Nine months ended September 25, 2016 and September 27, 2015</u>	6
<u>Notes to Condensed Consolidated Financial Statements</u>	7
<b><u>Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations</u></b>	15
<b><u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u></b>	24
<b><u>Item 4. Controls and Procedures</u></b>	25
<b><u>PART II. OTHER INFORMATION</u></b>	
<b><u>Item 1. Legal Proceedings</u></b>	25
<b><u>Item 1A. Risk Factors</u></b>	25
<b><u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u></b>	26
<b><u>Item 6. Exhibits</u></b>	26

Table of Contents

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## Papa John's International, Inc. and Subsidiaries

## Condensed Consolidated Balance Sheets

(In thousands, except per share amounts)	September 25, 2016 (Unaudited)	December 27, 2015
Assets		
Current assets:		
Cash and cash equivalents	\$ 19,107	\$ 21,006
Accounts receivable, net	59,046	63,320
Notes receivable, net	4,269	7,816
Income taxes receivable	701	272
Inventories	24,328	21,564
Prepaid expenses	15,633	20,372
Other current assets	8,584	8,941
Assets held for sale	8,784	9,299
Total current assets	140,452	152,590
Property and equipment, net	221,809	214,044
Notes receivable, less current portion, net	9,747	11,105
Goodwill	86,570	79,657
Deferred income taxes	1,428	2,415
Other assets	38,782	34,247
Total assets	\$ 498,788	\$ 494,058
Liabilities and stockholders' (deficit) equity		
Current liabilities:		
Accounts payable	\$ 37,302	\$ 43,492
Income and other taxes payable	11,909	8,527
Accrued expenses and other current liabilities	73,648	80,918
Total current liabilities	122,859	132,937
Deferred revenue	3,772	3,190
Long-term debt, net	311,570	255,146
Deferred income taxes	2,215	4,610
Other long-term liabilities	61,161	47,606
Total liabilities	501,577	443,489
Redeemable noncontrolling interests	8,830	8,363

Edgar Filing: PAPA JOHNS INTERNATIONAL INC - Form 10-Q

Stockholders' (deficit) equity:		
Preferred stock (\$0.01 par value per share; no shares issued)	—	—
Common stock (\$0.01 par value per share; issued 44,017 at September 25, 2016 and 43,731 at December 27, 2015)	440	437
Additional paid-in capital	167,626	158,348
Accumulated other comprehensive loss	(9,011)	(1,836)
Retained earnings	193,798	143,789
Treasury stock (7,227 shares at September 25, 2016 and 5,308 shares at December 27, 2015, at cost)	(377,481)	(271,557)
Total stockholders' (deficit) equity, net of noncontrolling interests	(24,628)	29,181
Noncontrolling interests in subsidiaries	13,009	13,025
Total stockholders' (deficit) equity	(11,619)	42,206
Total liabilities, redeemable noncontrolling interests and stockholders' (deficit) equity	\$ 498,788	\$ 494,058

See accompanying notes.

Table of Contents

Papa John's International, Inc. and Subsidiaries

Condensed Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	Three months ended		Nine Months Ended	
	September 25, 2016	September 27, 2015	September 25, 2016	September 27, 2015
<b>Revenues:</b>				
Domestic Company-owned restaurant sales	\$ 199,041	\$ 180,059	\$ 608,968	\$ 563,308
Domestic franchise royalties and fees	24,776	22,285	76,554	71,185
Domestic commissary and other sales	169,684	159,939	503,623	507,313
International	28,941	27,001	84,856	78,753
Total revenues	422,442	389,284	1,274,001	1,220,559
<b>Costs and expenses:</b>				
Operating costs (excluding depreciation and amortization shown separately below):				
Domestic Company-owned restaurant expenses	161,750	148,536	486,529	450,924
Domestic commissary and other expenses	157,552	148,709	466,616	470,254
International expenses	18,594	16,481	53,936	48,209
General and administrative expenses	40,549	37,660	123,419	124,456
Depreciation and amortization	10,614	10,461	30,389	30,638
Total costs and expenses	389,059	361,847	1,160,889	1,124,481
Operating income	33,383	27,437	113,112	96,078
Legal settlement expense	—	—	—	(12,278)
Net interest expense	(1,756)	(1,180)	(4,876)	(3,576)
Income before income taxes	31,627	26,257	108,236	80,224
Income tax expense	8,977	7,281	33,423	24,541
Net income before attribution to noncontrolling interests	22,650	18,976	74,813	55,683
Income attributable to noncontrolling interests	(1,183)	(1,005)	(4,623)	(4,696)
Net income attributable to the Company	\$ 21,467	\$ 17,971	\$ 70,190	\$ 50,987
<b>Calculation of income for earnings per share:</b>				
Net income attributable to the Company	\$ 21,467	\$ 17,971	\$ 70,190	\$ 50,987
Change in noncontrolling interest redemption value	(157)	49	342	192
Net income attributable to participating securities	(87)	(73)	(288)	(223)
Net income attributable to common shareholders	\$ 21,223	\$ 17,947	\$ 70,244	\$ 50,956
Basic earnings per common share	\$ 0.57	\$ 0.46	\$ 1.88	\$ 1.29
Diluted earnings per common share	\$ 0.57	\$ 0.45	\$ 1.86	\$ 1.27
	36,989	39,394	37,374	39,640

Edgar Filing: PAPA JOHNS INTERNATIONAL INC - Form 10-Q

Basic weighted average common shares outstanding				
Diluted weighted average common shares outstanding	37,359	39,895	37,712	40,210
Dividends declared per common share	\$ 0.200	\$ 0.175	\$ 0.550	\$ 0.455

See accompanying notes.

4

---



Table of Contents

Papa John's International, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands)	Three Months Ended		Nine Months Ended	
	September 25, 2016	September 27, 2015	September 25, 2016	September 27, 2015
Net income before attribution to noncontrolling interests	\$ 22,650	\$ 18,976	\$ 74,813	\$ 55,683
Other comprehensive (loss) income, before tax:				
Foreign currency translation adjustments	(2,038)	(1,700)	(5,551)	(1,125)
Interest rate swaps (1)	210	(1,386)	(5,839)	(2,011)
Other comprehensive loss, before tax	(1,828)	(3,086)	(11,390)	(3,136)
Income tax effect:				
Foreign currency translation adjustments	754	629	2,054	416
Interest rate swaps (2)	(78)	513	2,160	744
Income tax effect	676	1,142	4,214	1,160
Other comprehensive loss, net of tax	(1,152)	(1,944)	(7,176)	(1,976)
Comprehensive income before attribution to noncontrolling interests	21,498	17,032	67,637	53,707
Comprehensive loss, redeemable noncontrolling interests	(684)	(587)	(2,809)	(2,915)
Comprehensive loss, nonredeemable noncontrolling interests	(499)	(418)	(1,814)	(1,781)
Comprehensive income attributable to the Company	\$ 20,315	\$ 16,027	\$ 63,014	\$ 49,011

(1) Amounts reclassified out of accumulated other comprehensive loss into net interest expense included \$296 and \$924 for the three and nine months ended September 25, 2016, respectively, and \$390 and \$1,177 for the three and nine months ended September 27, 2015, respectively.

(2) The income tax effects of amounts reclassified out of accumulated other comprehensive loss into net interest expense were \$110 and \$342 for the three and nine months ended September 25, 2016, respectively, and \$145 and \$436 for the three and nine months ended September 27, 2015, respectively.

See accompanying notes.



Table of Contents

Papa John's International, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Nine Months Ended	
	September 25, 2016	September 27, 2015
Operating activities		
Net income before attribution to noncontrolling interests	\$ 74,813	\$ 55,683
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for uncollectible accounts and notes receivable	153	813
Depreciation and amortization	30,389	30,638
Deferred income taxes	4,966	(7,625)
Stock-based compensation expense	7,525	7,124
Other	2,811	3,268
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	3,867	(1,994)
Income taxes receivable	(429)	8,731
Inventories	(2,673)	2,178
Prepaid expenses	4,755	2,033
Other current assets	872	367
Other assets and liabilities	(3,085)	819
Accounts payable	(6,290)	(3,380)
Income and other taxes payable	3,381	375
Accrued expenses and other current liabilities	(6,484)	20,508
Deferred revenue	1,411	200
Net cash provided by operating activities	115,982	119,738
Investing activities		
Purchases of property and equipment	(38,954)	(26,508)
Loans issued	(2,216)	(2,497)
Repayments of loans issued	6,449	3,961
Acquisitions, net of cash acquired	(11,202)	(491)
Other	193	406
Net cash used in investing activities	(45,730)	(25,129)
Financing activities		
Net proceeds from issuance of long-term debt	56,375	8,549
Cash dividends paid	(20,523)	(17,950)
Excess tax benefit on equity awards	5,474	9,884

Edgar Filing: PAPA JOHNS INTERNATIONAL INC - Form 10-Q

Tax payments for equity award issuances	(5,999)	(10,947)
Proceeds from exercise of stock options	5,377	4,569
Acquisition of Company common stock	(109,407)	(80,166)
Distributions to noncontrolling interest holders	(3,830)	(4,267)
Other	481	377
Net cash used in financing activities	(72,052)	(89,951)
Effect of exchange rate changes on cash and cash equivalents	(99)	(339)
Change in cash and cash equivalents	(1,899)	4,319
Cash and cash equivalents at beginning of period	21,006	20,122
Cash and cash equivalents at end of period	\$ 19,107	\$ 24,441

See accompanying notes.

Table of Contents

Papa John's International, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

September 25, 2016

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (“GAAP”) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete annual financial statements. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Operating results for the three and nine months ended September 25, 2016 are not necessarily indicative of the results that may be expected for the fiscal year ended December 25, 2016. For further information, refer to the consolidated financial statements and footnotes thereto included in the Annual Report on Form 10-K for Papa John's International, Inc. (referred to as the “Company”, “Papa John's” or in the first person notations of “we”, “us” and “our”) for the year ended December 27, 2015.

2. Significant Accounting Policies

Noncontrolling Interests

Papa John's has four joint venture arrangements in which there are noncontrolling interests held by third parties. These joint ventures include 215 restaurants at September 25, 2016 and 208 restaurants at September 27, 2015. We are required to report the consolidated net income at amounts attributable to the Company and the noncontrolling interests. Additionally, disclosures are required to clearly identify and distinguish between the interests of the Company and the interests of the noncontrolling owners, including a disclosure on the face of the condensed consolidated statements of income attributable to the noncontrolling interest holder.

The income before income taxes attributable to these joint ventures for the three and nine months ended September 25, 2016 and September 27, 2015 was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 25, 2016	September 27, 2015	September 25, 2016	September 27, 2015
Papa John's International, Inc.	\$ 1,879	\$ 1,570	\$ 7,168	\$ 7,240
Noncontrolling interests	1,183	1,005	4,623	4,696
Total income before income taxes	\$ 3,062	\$ 2,575	\$ 11,791	\$ 11,936

7

---

Table of Contents

The following summarizes the redemption feature, location and related accounting within the condensed consolidated balance sheets for these joint venture arrangements:

Type of Joint Venture Arrangement	Location within the Condensed Consolidated Balance Sheets	Recorded Value
Joint venture with no redemption feature	Permanent equity	Carrying value
Option to require the Company to purchase their interest - currently redeemable	Temporary equity	Redemption value*
Option to require the Company to purchase their interest - not currently redeemable	Temporary equity	Carrying value

---

\*The change in redemption value is recorded as an adjustment to “Redeemable noncontrolling interests” and “Retained earnings” in the condensed consolidated balance sheets.

#### Deferred Income Tax Accounts and Tax Reserves

We are subject to income taxes in the United States and several foreign jurisdictions. Significant judgment is required in determining our provision for income taxes and the related assets and liabilities. The provision for income taxes includes income taxes paid, currently payable or receivable and those deferred. We use an estimated annual effective rate based on expected annual income to determine our quarterly provision for income taxes. Discrete items are recorded in the quarter in which they occur.

Deferred tax assets and liabilities are determined based on differences between financial reporting and tax basis of assets and liabilities and are measured using enacted tax rates and laws that are expected to be in effect when the differences reverse. Deferred tax assets are also recognized for the estimated future effects of tax loss carryforwards. The effect on deferred taxes of changes in tax rates is recognized in the period in which the new tax rate is enacted. As a result, our effective tax rate may fluctuate. Valuation allowances are established when necessary on a jurisdictional basis to reduce deferred tax assets to the amounts we expect to realize. As of September 25, 2016, we had a net deferred tax liability of approximately \$800,000.

Tax authorities periodically audit the Company. We record reserves and related interest and penalties for identified exposures as income tax expense. We evaluate these issues on a quarterly basis to adjust for events, such as statute of limitations expirations, court rulings or audit settlements, which may impact our ultimate payment for such exposures.

Fair Value Measurements and Disclosures

The Company is required to determine the fair value of financial 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. Fair value is a market-based measurement, not an entity specific measurement. The fair value of certain assets and liabilities approximates carrying value because of the short-term nature of the accounts, including cash, accounts receivable and accounts payable. The carrying value of our notes receivable net of allowances also approximates fair value. The fair value of the amount outstanding under our revolving credit facility approximates its carrying value due to its variable market-based interest rate. These assets and liabilities are categorized as Level 1 as defined below.

Certain assets and liabilities are measured at fair value on a recurring basis and are required to be classified and disclosed in one of the following categories:

- Level 1: Quoted market prices in active markets for identical assets or liabilities.
  - Level 2: Observable market-based inputs or unobservable inputs that are corroborated by market data.
- Level 3: Unobservable inputs that are not corroborated by market data.



Table of Contents

Our financial assets and liabilities that were measured at fair value on a recurring basis as of September 25, 2016 and December 27, 2015 are as follows (in thousands):

	Carrying Value	Fair Value Measurements		
		Level 1	Level 2	Level 3
September 25, 2016				
Financial assets:				
Cash surrender value of life insurance policies (a)	\$ 21,451	\$ 21,451	\$ —	\$ —
Financial liabilities:				
Interest rate swaps (b)	8,130	—	8,130	—
December 27, 2015				
Financial assets:				
Cash surrender value of life insurance policies (a)	\$ 17,916	\$ 17,916	\$ —	\$ —
Financial liabilities:				
Interest rate swaps (b)	2,262	—	2,262	—

(a) Represents life insurance policies held in our non-qualified deferred compensation plan.

(b) The fair value of our interest rate swaps are based on the sum of all future net present value cash flows. The future cash flows are derived based on the terms of our interest rate swaps, as well as considering published discount factors, and projected London Interbank Offered Rates (“LIBOR”).

There were no transfers among levels within the fair value hierarchy during the nine months ended September 25, 2016.

## Variable Interest Entity

Papa John’s domestic restaurants, both Company-owned and franchised, participate in Papa John’s Marketing Fund, Inc. (“PJMF”), a nonstock corporation designed to operate at break-even for the purpose of designing and administering advertising and promotional programs for all participating domestic restaurants. PJMF is a variable interest entity as it does not have sufficient equity to fund its operations without ongoing financial support and contributions from its members. Based on the ownership and governance structure and operating procedures of PJMF, we have determined that we do not have the power to direct the most significant activities of PJMF and therefore are not the primary beneficiary. Accordingly, consolidation of PJMF is not appropriate.

## Accounting Standards Adopted

#### Deferred Debt Issuance Costs

In April 2015, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2015-03 “Interest – Imputation of Interest: Simplifying the Presentation of Debt Issuance Costs” (“ASU 2015-03”). The update requires that deferred debt issuance costs be reported as a reduction to long-term debt (previously reported in other noncurrent assets). We adopted ASU 2015-03 in the first quarter of 2016 and for all retrospective periods, as required. The impact of the adoption was not material to our condensed consolidated financial statements. See Debt Footnote for more details.

#### Accounting Standards to be Adopted in Future Periods

#### Employee Share-Based Payments

In March 2016, the FASB issued ASU 2016-09, “Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting” (“ASU 2016-09”). The guidance changes how companies account for certain aspects of share-based payment awards to employees, including the accounting for income taxes, forfeitures, and statutory tax

## Table of Contents

withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for the Company beginning in fiscal 2017, with early application permitted. Based on the significance of our employee stock compensation program, we expect the adoption could have a material impact to our condensed consolidated statements of income.

## Leases

In February 2016, the FASB issued ASU 2016-02, “Leases,” (“ASU 2016-02”) which amends leasing guidance by requiring companies to recognize a right-of-use asset and a lease liability for all operating and capital leases (financing) with lease terms greater than twelve months. The lease liability will be equal to the present value of lease payments. The lease asset will be based on the lease liability, subject to adjustment, such as for initial direct costs. For income statement purposes, leases will continue to be classified as operating or capital (financing) with lease expense in both cases calculated substantially the same as under the prior leasing guidance. ASU 2016-02 is effective for interim and annual periods beginning after December 15, 2018 (fiscal 2019 for the Company), and early adoption is permitted. The Company has not yet determined the effect of the adoption on its condensed consolidated financial statements.

## Revenue from Contracts with Customers

In May 2014, the FASB issued ASU 2014-09 “Revenue from Contracts with Customers” (“ASU 2014-09”), a comprehensive new revenue recognition standard that will supersede nearly all existing revenue recognition guidance under GAAP. This update requires companies to recognize revenue at amounts that reflect the consideration to which the company expects to be entitled in exchange for those goods or services at the time of transfer. In doing so, companies will need to use more judgment and make more estimates than under existing guidance. Such estimates may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Companies can either apply a full retrospective adoption or a modified retrospective adoption.

We are required to adopt ASU 2014-09 in the first quarter of 2018. We are currently evaluating the method of adoption and impact of the new requirements on our condensed consolidated financial statements. We currently do not believe the impact will be significant.

## Reclassifications

Certain prior year captions have been combined in the condensed consolidated statement of income and certain amounts within the consolidated statement of cash flows have been reclassified to conform to the current year presentation.

### 3. Calculation of Earnings Per Share

We compute earnings per share using the two-class method. The two-class method requires an earnings allocation formula that determines earnings per share for common shareholders and participating security holders according to dividends declared and participating rights in undistributed earnings. We consider time-based restricted stock awards to be participating securities because holders of such shares have non-forfeitable dividend rights. Under the two-class method, undistributed earnings allocated to participating securities are subtracted from net income attributable to the Company in determining net income attributable to common shareholders.

Additionally, in accordance with Accounting Standards Codification (“ASC”) 480, “Distinguishing Liabilities from Equity”, the change in the redemption value for the noncontrolling interest of one of our joint ventures increases or decreases income attributable to common shareholders.

Table of Contents

The calculations of basic and diluted earnings per common share are as follows (in thousands, except per-share data):

Three Months Ended	Nine Months Ended
September 25	September 27,