Papa Murphy's Holdings, Inc.
Form 10-Q
May 22, 2014

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

FORM 10-Q

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the quarterly period ended March 31, 2014
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)	27-2349094 (IRS Employer Identification No.)
8000 NE Parkway Drive, Suite 350 Vancouver, WA (Address of principal executive offices)	98662 (Zip Code)
(360) 260-7272 (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 [X].
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 [X]. No [ ].
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See 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 [X]	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 [X].
At May 21, 2014, there were 16,967,403 shares of the Registrant's common stock, $0.01 par value, outstanding.

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PART I — FINANCIAL INFORMATION
Item 1. Financial Statements
PAPA MURPHY'S HOLDINGS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Operations and Comprehensive Income
(In thousands of dollars, except per share data)
(Unaudited)

	Three Months Ended	
	March 31, 2014	April 1, 2013
Revenues		
Franchise royalties	$10,069	$9,503
Franchise and development fees	1,169	882
Company-owned store sales	12,018	9,166
Lease and other	1,861	42
Total revenues	25,117	19,593
Costs and Expenses		
Store operating costs (exclusive of depreciation and amortization shown separately below):		
Cost of food and packaging	4,590	3,423
Compensation and benefits	3,030	2,572
Advertising	1,122	846
Occupancy	660	554
Other store operating costs	1,069	930
Selling, general, and administrative	8,199	5,734
Depreciation and amortization	1,841	1,699
Loss on disposal or impairment of property and equipment	6	64
Total costs and expenses	20,517	15,822
Operating Income	4,600	3,771
Interest expense	3,112	2,616
Interest income	(34)	(22)
Other expense, net	12	7
Income Before Income Taxes	1,510	1,170
Provision for income taxes	691	459
Net Income	819	711
Other Comprehensive Income		
Foreign currency translation adjustment	—	—
Total Comprehensive Income	$819	$711
Loss per share of common stock		
Basic	$(0.20)	$(0.23)
Diluted	$(0.20)	$(0.23)
Weighted average common stock outstanding		
Basic	3,851,741	3,797,209
Diluted	3,851,741	3,797,209

See accompanying notes.

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PAPA MURPHY’S HOLDINGS, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets
(In thousands of dollars, except par value and share data)

	March 31, 2014 (unaudited)	December 30, 2013
Assets		
Current Assets		
Cash and cash equivalents	$2,241	$3,705
Accounts receivable, net	4,158	2,430
Notes receivable (including related party notes of $41 and $39, respectively)	54	837
Inventories	482	495
Prepaid expenses and other current assets	7,476	7,054
Current deferred tax asset	1,811	1,856
Total current assets	16,222	16,377
Property and equipment, net	9,607	9,660
Notes receivable, net (including related party notes of $392 and $444, respectively)	392	444
Goodwill	96,080	96,089
Trade name and trademarks	87,002	87,002
Definite-life intangibles, net	47,512	48,744
Deferred finance charges, net	3,733	3,934
Other assets	2,752	2,252
Total assets	$263,300	$264,502
Liabilities and Equity		
Current Liabilities		
Accounts payable	$2,212	$3,673
Accrued and other liabilities	7,368	9,741
Unearned franchise and development fees	2,945	2,881
Current portion of long-term debt	1,670	1,670
Total current liabilities	14,195	17,965
Long-term debt, net of current portion	169,330	168,330
Unearned franchise and development fees	1,160	1,113
Deferred tax liability	41,873	41,465
Other long-term liabilities	1,472	1,482
Total liabilities	228,030	230,355
Commitments and contingencies (Note 14)		
Equity		
Papa Murphy’s Holdings Inc. Shareholders’ Equity		
Series A preferred stock ($0.01 par value; 3,000,000 shares authorized; 2,853,809 and 2,853,809 shares issued and outstanding, respectively (aggregate liquidation preference $63,059 and $61,476, respectively))	60,156	60,156
Series B preferred stock ($0.01 par value; 1,000,000 shares authorized, 26,551 and 26,551 shares issued and outstanding, respectively (aggregate liquidation preference $737 and $722, respectively))	741	741
Common stock ($0.01 par value; 200,000,000 shares authorized; 4,222,265 and 4,347,882 shares issued and outstanding, respectively)	42	43
Additional paid-in capital	747	1,555

Stock subscription receivable	(140)	(1,197)
Accumulated deficit	(26,554)	(27,373)
Total Papa Murphy’s Holdings Inc. shareholders’ equity	34,992	33,925
Noncontrolling interests	278	222
Total equity	35,270	34,147
Total liabilities and equity	$263,300	$264,502

See accompanying notes.

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PAPA MURPHY'S HOLDINGS, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(In thousands of dollars)
(Unaudited)

	Three Months Ended March 31, 2014	Three Months Ended April 1, 2013
Operating Activities		
Net income	$819	$711
Adjustments to reconcile net income to net cash from operating activities		
Depreciation and amortization	1,841	1,699
Loss on disposal or impairment of property and equipment	6	64
Non-cash employee equity compensation	550	15
Amortization of deferred finance charges	207	198
Change in operating assets and liabilities		
Trade and other receivables	(1,728)	52
Inventories	13	(6)
Prepaid expenses and other current assets	(543)	944
Unearned franchise and development fees	111	447
Accounts payable	(1,514)	(330)
Accrued expenses	(2,361)	(1,714)
Deferred taxes	453	389
Other assets and liabilities	6	(5)
Net cash from operating activities	(2,140)	2,464
Investing Activities		
Acquisition of property and equipment	(538)	(284)
Acquisition of stores, less cash acquired	(130)	(1,823)
Proceeds from sale of stores	21	—
Payments received on notes receivable	824	7
Investment in cost-method investee	(500)	—
Net cash from investing activities	(323)	(2,100)
Financing Activities		
Payments on long-term debt	—	(220)
Advances on revolver	1,000	500
Payments on revolver	—	(1,000)
Issuance of common stock	—	27
Repurchases of common stock	(1,108)	—
Debt issuance and modification costs, including prepayment penalties	(6)	(277)
Payments received on subscription receivables	1,057	—
Investment by noncontrolling interest holders	56	—
Net cash from financing activities	999	(970)
Net change in cash and cash equivalents	(1,464)	(606)
Cash and Cash Equivalents, beginning of year	3,705	2,428
Cash and Cash Equivalents, end of period	$2,241	$1,822

Supplemental Disclosures of Cash Flow Information

Cash paid during the period for interest	$3,110	$2,465
Cash paid during the period for income taxes	$5	$(14)
Noncash Supplemental Disclosures of Investing and Financing Activities		
Issuance of note receivable for preferred and common stock	—	54
Acquisition of property and equipment in accounts payable	53	50

See accompanying notes.

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PAPA MURPHY'S HOLDINGS, INC. AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
Note 1—Description of Business and Basis of Presentation
Description of business—Papa Murphy's Holdings, Inc. ("Papa Murphy's" or the "Company"), together with its subsidiaries, is a franchisor and operator of a Take 'N' Bake pizza chain. The Company franchises the right to operate Take 'N' Bake pizza franchises and operates Take 'N' Bake pizza stores owned by the Company. As of March 31, 2014, the Company had 1,429 stores comprised of 1,405 domestic stores (1,336 franchised stores and 69 company-owned stores) across 38 states, plus 24 franchised stores in Canada and the United Arab Emirates.

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 cash proceeds of $59.7 million from this transaction, net of underwriting discounts and commissions. All share and per share data have been retroactively restated in the accompanying financial statements to give effect to a stock split. See Note 17 "Subsequent Events" for more information.

Basis of presentation—The accompanying interim unaudited condensed consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "Commission"). 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 for the year ended December 30, 2013 included in the Company's Registration Statement (Registration No. 333-194488) which was declared effective by the Commission on May 1, 2014 (as amended, the "Registration Statement").

Principles of consolidation—The interim unaudited condensed consolidated financial statements includes the accounts of Papa Murphy's Holdings, Inc. and its subsidiaries. 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 these Notes, "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 2014 and 2013 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 2014 and 2013 are references to fiscal years ended December 29, 2014 and December 30, 2013, respectively.

Internal use software—Expenditures for major software purchases and software developed for internal use are capitalized and amortized over the useful life of the software (3 - 5 years) on a straight-line basis. The Company's policy provides for the capitalization of external direct costs of materials and services associated with developing or obtaining internal-use computer software. Costs associated with preliminary project stage activities, training, maintenance and all other post-implementation stage activities are expensed as incurred.

Software revenue recognition—The Company recognizes revenues for the resale of software licenses upon delivery to franchise owners to the extent collectability is probable. In an effort to obtain more favorable pricing and expedite the roll-out of point-of-sale ("POS") systems, the Company acquired $4.5 million of POS software licenses in a lump sum purchase in 2013 and intends to resell them to franchise owners at cost within the next 9-12 months.

Recent accounting pronouncements—In July 2013, the FASB issued ASU No. 2013-11, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists, which prescribes that an unrecognized tax benefit or a portion of an unrecognized tax benefit should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar loss, or a tax credit carryforward, except in certain cases where the unrecognized tax benefit should be presented as a liability and should not be combined with deferred tax assets. This update is effective for fiscal years, and interim periods within those years,

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beginning after December 15, 2013, with early adoption permitted. This update should be applied prospectively to all unrecognized tax benefits that exist at the effective date, with retrospective application permitted. The Company adopted ASU No. 2013-11 effective December 30, 2013. The adoption concerns presentation and disclosure only and did not have an impact on the Company’s consolidated financial position or results of operations.

Note 2—Prepaid Expenses and Other Current Assets

Prepaid expenses and other current assets are comprised of the following (in thousands):

	March 31, 2014	December 30, 2013
Prepaid media development costs	$800	$16
Prepaid rents and insurance	554	458
Equity issuance costs	2,911	1,537
Other prepaid expenses	462	363
Subtotal prepaid expenses	4,727	2,374
POS software licenses	2,748	4,548
Other current assets	1	132
Subtotal other current assets	2,749	4,680
Total prepaid expenses and other current assets	$7,476	$7,054

Prepaid media development costs represent costs incurred for advertisements that have not aired. During the three months ended March 31, 2014, the Company recognized $1.8 million in software license revenue upon the resale of POS software licenses to franchisees at cost. The income from the sale is included in Lease and other and the related expense is recorded in Selling, general and administrative expenses on the Condensed Consolidated Statement of Operations and Comprehensive Income.

Note 3—Property and Equipment

Property and equipment are net of accumulated depreciation of $7,031,000 and $6,480,000 at March 31, 2014 and December 30, 2013, respectively. Depreciation expense for the three months ended March 31, 2014 and April 1, 2013 was $609,000 and $603,000, respectively.

Note 4—Goodwill

The following summarizes changes to the Company’s goodwill, by reportable segment (in thousands):

	DOMESTIC COMPANY STORES	DOMESTIC FRANCHISE	TOTAL
Balance at December 30, 2013	$ 14,543	$81,546	$96,089
Disposition	(9)	—	(9)
Balance at March 31, 2014	$ 14,534	$81,546	$96,080

There is no goodwill associated with the International Segment. During the three months ended March 31, 2014, the Company has determined that there have not been any triggering events that would require an updated impairment review.

Note 5—Intangible Assets

Intangible assets are net of accumulated amortization of $15,468,000 and $14,283,000 as of March 31, 2014 and December 30, 2013, respectively. Amortization expense for the three months ended March 31, 2014 and April 1, 2013 was $1,232,000 and $1,096,000, respectively.

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Note 6—Notes Receivable

Notes receivable consists of the following (in thousands):

	March 31, 2014	December 30, 2013
Note issued on sale of company-owned restaurants maturing in 2020, bearing interest at 9.0%. Monthly payments of principal and interest of $6 are due through July 2014. Monthly payment amounts increase annually pursuant to an agreed schedule until they reach a monthly maximum of $9 in August 2018. Collateralized by restaurant assets.	$433	$443
Uncollateralized note issued to an employee, maturing from 2013 to 2017, bearing interest between 0.88% and 6.0%.	—	40
Total related party notes receivable	433	483
Notes issued to finance franchise owners' purchase of point of sale systems, three year term, maturing during 2014 and bearing interest at 10.5%. Monthly payments of principal and interest due through 2014. Collateralized by POS systems.	13	23
Note issued on the sale of company-owned restaurants maturing during 2015, denominated in Canadian dollars, bearing interest at 4%. Monthly payment terms of interest only through 2015. Collateralized by restaurant assets.	799	825
Note issued on the sale of company-owned restaurants maturing during 2014, bearing interest at 8%. Monthly payment terms of interest only through 2014. Collateralized by restaurant assets.	—	775
Total notes receivable	1,245	2,106
Less allowance for doubtful notes receivable	(799)	(825)
Notes receivable, net of allowance for doubtful notes receivable	446	1,281
Less current portion	(54)	(837)
Notes receivable, net of current position	$392	$444

Note 7—Financing Arrangements

Long-term debt is comprised of the following (in thousands):

	March 31, 2014	December 30, 2013
Senior secured credit facility		
Term loan	$167,000	$167,000
Revolving line of credit	1,000	—
Notes payable	3,000	3,000
Total long-term debt	171,000	170,000
Less current portion	(1,670)	(1,670)
Total long-term debt, net of current portion	$169,330	$168,330

PMI Holdings Inc., a wholly-owned subsidiary of the Company, has a $177.0 million senior secured credit facility consisting of a $167.0 million senior secured term loan and a $10 million revolving credit facility, which includes a $2.5 million letter of credit subfacility. The senior secured credit facility matures in October 2018. The senior secured credit facility bore interest at a rate of 6.75% for the first quarter of 2014.

A wholly-owned subsidiary of the Company has a note payable for $3 million which bears interest at 5% and matures in December 2018. This note is subordinated to the senior secured credit facility.

Note 8—Fair Value Measurement

The fair value of cash and cash equivalents, accounts receivables and accounts payable approximates carrying value because of the short-term nature of the accounts. The fair value of notes receivable was $462,000 and $1.3 million as of March 31, 2014 and December 30, 2013, respectively, and was based on Level 3 inputs. The fair value of the notes

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receivable was estimated primarily using a discounted cash flow method based on a discount rate, reflecting the applicable credit spread. The fair value of long-term debt, including the current portion thereof, was approximately $169.7 million and $168.9 million as of March 31, 2014 and December 30, 2013, respectively, and was based on Level 3 inputs. 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. The fair value of our investment in Project Pie, a cost-method investee, approximates book value due to the recent nature of the investment and subsequent investments.

Note 9—Accrued and Other Liabilities

Accrued and other liabilities are comprised of the following (in thousands):

	March 31, 2014	December 30, 2013
Accrued payable for POS software licenses	$1,882	$2,729
Accrued compensation and related costs	1,709	2,232
Gift cards and certificates payable	2,238	2,829
Accrued interest and non-income taxes payable	258	384
Convention fund	496	576
Other	785	991
	$7,368	$9,741

Note 10—Income Taxes

The Company recognized an income tax expense of $0.7 million on income before income taxes of $1.5 million, or an effective tax rate of 45.8%, for the three months ended March 31, 2014, compared to income tax expense of $0.5 million on income before income taxes of $1.2 million, or an effective tax rate of 39.2%, for the three months ended April 1, 2013. The effective tax rate for the first three months of 2014 includes the impact of a discrete adjustment for accelerated vesting of restricted stock.

Note 11—Shareholders' Equity

Preferred stock—The Company's preferred stock consists of Series A Preferred Shares (the "Series A Preferred Shares") and Series B Preferred Shares (the "Series B Preferred Shares," and together with the Series A Preferred Shares, the "Preferred Shares"). The Preferred Shares have 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 are entitled to receive the unpaid liquidation value plus accreted dividends before any distribution may be made to the holders of common stock. In addition, the Preferred Shares participate 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 March 31, 2014.

The holders of preferred and common stock are entitled to one vote per share solely voting together as a single class and are not entitled to vote separately as a class on any matter.

Noncontrolling interests—During the three months ended March 31, 2014 the Company received an additional investment of $56,000 by noncontrolling interest holders in its majority-owned subsidiary Project Pie Holdings, LLC.

Note 12—Share-based Compensation

Restricted common shares and stock options—In May 2010, the Company's Board of Directors approved the 2010 Amended Management Incentive Plan (the "2010 Plan"), which, as amended, reserves 916,747 common shares for equity incentive awards consisting of incentive stock options, non-qualified stock options, restricted stock awards, and unrestricted stock awards. Under the 2010 Plan, the Company has sold 628,160 and 753,783 shares of restricted common stock to eligible employees as of March 31, 2014 and December 30, 2013, respectively. In addition, the Company has issued 183,322 and zero stock options under the 2010 Plan to eligible employees as of March 31, 2014 and December 30, 2013, respectively.

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Information with respect to restricted stock sales is as follows:

	NUMBER OF SHARES OF RESTRICTED COMMON STOCK		
	TIME VESTING	MARKET CONDITION VESTING	WEIGHTED AVERAGE SALE DATE FAIR VALUE
Unvested, December 30, 2013	243,475	236,707	$ 2.49
Sold/Granted	—	—	—
Vested	(30,174)	(4,555)	11.11
Forfeited/Repurchased	(5,731)	(5,280)	0.37
Unvested, March 31, 2014	207,570	226,872	$ 2.08

Information with respect to stock option activity is as follows:

	NUMBER OF SHARES OF STOCK OPTIONS				
	TIME VESTING	MARKET VESTING	WEIGHTED AVERAGE EXERCISE PRICE	WEIGHTED AVERAGE REMAINING CONTRACTUAL TERM	AGGREGATE INTRINSIC VALUE (in thousands)
Outstanding, December 30, 2013	—	—	$—		
Granted	154,253	29,069	11.85		
Exercised	—	—	—		
Forfeited	—	—	—		
Outstanding, March 31, 2014	154,253	29,069	$11.85	10.0 years	$ —
Exercisable, March 31, 2014	78,072	—	$11.85	10.0 years	$ —
Vested and expected to vest at March 31, 2014	150,444	27,616	$11.85	10.0 years	$ —

The weighted average fair value of share-based compensation awards granted and vested, and the intrinsic value of options exercised during the period were (in thousands, except per share amounts):

	Three Months Ended	
	March 31, 2014	April 1, 2013
Restricted Stock Sales:		
Weighted average sale date fair value per share	$—	$6.53
Total fair value of shares sold	$—	$111
Total fair value of shares vested	$386	$—
Stock Option Awards:		
Weighted average grant date fair value per share	$4.28	$—
Total fair value of awards granted	$784	$—
Total fair value of awards vested	$285	$—
Total intrinsic value of options exercised	$—	$—

Compensation cost and valuation—Total compensation costs recognized in connection with the above-mentioned restricted common stock, unrestricted common stock and Preferred Shares for the three months ended March 31, 2014 and April 1, 2013 were $550,000 and $15,000, respectively. Income tax benefits recognized for the three months ended March 31, 2014 and April 1, 2013 were $116,000 and zero, respectively.

As of March 31, 2014, the total unrecognized stock-based compensation expense, net of estimated forfeitures, was $554,000 and the remaining weighted average contractual life was 3.0 years.
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

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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. In estimating the fair value of the aggregate value of the Company, the Company considered both the income approach and the market approach.

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, the Company assumed the following:

	Three Months Ended	
	March 31, 2014	April 1, 2013
Risk free rate	0.36%	0.28%
Volatility of the underlying assets	45%	40%
Estimated time until a liquidation event	(A)	2.25 years
Marketability discount—common stock	(A)	30%
Marketability discount—preferred stock	(A)	15%

(A) On July 1, 2013, the Company began to apply a probability weighted expected return method, where equity values were calculated using an option pricing model under an IPO and non-IPO scenarios and each value was weighted based on estimated probability of occurrence. During the period, 0.58~1.75 years were used as estimated time until a liquidation event and 10~25% and 8~15% of marketability discount were used for common and preferred stock, respectively, depending on an IPO or non-IPO scenarios. As of March 31, 2014, 95% weight was applied to an IPO scenario.

The fair value of the stock option awards granted in the three months ended March 31, 2014 was estimated with the following weighted-average assumptions.

	Three Months Ended	
	March 31, 2014	April 1, 2013
Risk free rate	1.9%	—
Expected volatility	35.3%	—
Expected term	5.6 years	—
Expected dividend yield	0.0%	—

Preferred and common stock subject to put options—In July 2011, the Company entered into a share repurchase and put option agreement with an executive officer, pursuant to which the executive officer has the right and option to have the Company repurchase 74,491 shares of unrestricted preferred stock and 92,951 shares (41,075 pre-stock split) of unrestricted common stock, which the employee previously acquired at fair value, at a redemption value on December 31 of any given calendar year following December 31, 2011 ("Put Option") after a certain condition is met. In December 2012, the Put Option became exercisable.

The Put Option was considered compensatory in nature as it was entered into in conjunction with an employment agreement modification. The combined shares and Put Option were evaluated in accordance with ASC Topic 718 and determined to be a liability-classified instrument on the date the Put Option was granted to the employee. Subsequent changes to the combined fair value of the shares and embedded Put Option are recorded as compensation expense. The fair value of the preferred and common stock subject to put options was determined by adding the fair value of put options to the fair value of common and preferred stock. The fair value of put options was determined using an option pricing method in a Monte Carlo simulation framework where total equity value at the hypothetical exit event among various equity classes of the Company was simulated and the payoff at the exercise of the put options was calculated based on the exercise price of the put options and the share values in each simulated scenario. The payoff of the put options in all scenarios was averaged and a present value calculated for each valuation date. The change in the fair value of the Put Option during the three months ended April 1, 2013 resulted in a reduction in compensation expense of $48,000. In December 2013, the share repurchase and put option agreement was canceled.

Note 13—Earnings per Share (EPS)

The number of shares and earnings per share data ("EPS") for all periods presented are based on the historical weighted-average shares of common stock outstanding. EPS is computed using the two-class method. The two-class method

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determines EPS for common stock and participating securities according to dividends and dividend equivalents and their respective participation rights in undistributed earnings. The Company's cumulative preferred stockholders are entitled to participate in 20% of all remaining earnings or dividends if distributed to common stockholders. As such, the Company has calculated EPS using the two-class method.

EPS is calculated by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding during each period. Diluted earnings per share ("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 restricted common stock. 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 earnings per share (in thousands, except per share data):

	Three Months Ended	
	March 31, 2014	April 1, 2013
Earnings:		
Net income	$819	$711
Less: cumulative Series A and B Preferred dividends not subject to put options	(1,598)	(1,592)
Net loss available to common stockholders	$(779)	$(881)
Shares:		
Weighted average common shares outstanding	3,852	3,797
Dilutive effect of restricted equity awards*	—	—
Diluted weighted average number of shares outstanding	3,852	3,797
Loss per share:		
Basic loss per share	$(0.20)	$(0.23)
Diluted loss per share	$(0.20)	$(0.23)

* Unvested restricted stock was not included in the computation of diluted earnings per share for the three months ended March 31, 2014 and April 1, 2013 since the effect would have been anti-dilutive. For the three months ended March 31, 2014 and April 1, 2013, an aggregated total of 255,000 shares and 301,000 shares have been excluded from the diluted income per share calculation since their effect would have been anti-dilutive.

Note 14—Commitments and Contingencies

Commitment to purchase additional equity subscriptions—In connection with the acquisition of Project Pie, LLC, the Company has committed to fund, upon demand, up to an additional $2.0 million prior to December 2016 in increments of $500,000 through the purchase of additional Series A Preferred Units. The number of units to be purchased will be determined based upon the then-current pre-money valuation in accordance with the Unit Purchase Agreement. During the three months ended March 31, 2014 the Company invested an additional $500,000 in Series A Preferred Units of Project Pie, LLC.

Operating lease commitments—The Company leases facilities and various office equipment under non-cancelable operating leases which expire through March 2019. 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 various operating leases that it has subleased to franchise owners. These operating leases have minimum base rent terms and contingent rent terms if individual franchise store sales exceed certain levels.

Lease guarantees—The Company is the guarantor for operating leases of six franchise owner store locations, including four locations that the Company is subleasing, that have terms expiring on various dates from April 2014 to September 2018. The obligation from these leases will generally continue to decrease over time as the leases expire. As of March 31, 2014, the Company does not believe it is probable it would be required to perform under the

outstanding guarantees. The applicable franchise owners continue to have primary liability for these operating leases.
Legal proceedings—The Company is currently subject to litigation with a group of franchise owners. In January 2014, eight franchise owners 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 in order to address and resolve these claims, but was unable to reach a settlement agreement. On April 4, 2014, a total of 12 franchise owner groups, including these franchise owners, representing 52 open franchise stores, filed a lawsuit against the Co

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mpany in Washington State court making essentially the same allegations for violation of the Washington Franchise Investment Protection Act, fraud, negligent misrepresentation and breach of contract. The Company believes the allegations lack merit and is vigorously defending the lawsuit. On May 2, 2014, the Company filed a Partial Motion to Dismiss and an Answer in the lawsuit. The Company cannot assure that it will be successful in defending against the lawsuit; however, it does not currently expect the cost of resolving this matter to have a material adverse effect on its consolidated financial position, results of operations, or cash flows.

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

Note 15—Related Party Transactions

Advisory services and monitoring agreement—As of March 31, 2014, the Company was a party to an advisory services and monitoring agreement with affiliates of Lee Equity Partners, LLC. ("Sponsor"). In accordance with the terms of the agreement, the Company pays the related party for ongoing advisory and monitoring services such as management consulting, financial analysis, and other related services. As compensation, the Company has agreed to pay an annual fee of $500,000 in four equal quarterly installments plus direct expenses incurred which are included in selling, general and administrative expenses. The agreement calls for no minimum level of services to be provided and fees paid to the related party can be deferred at the discretion of the related party or if required by the credit facility. In connection with an IPO, the Company would be required to pay the Sponsor an amount not to exceed $1.5 million in accordance with the terms of the agreement. The agreement automatically terminated immediately prior to the IPO.

On May 7, 2014, the Company completed an IPO (see Note 17—Subsequent Events) and paid the Sponsor $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 the Sponsor has been terminated.

Employee loans related to share purchases (see Note 12—Share-based Compensation)—In connection with share-based compensation, the Company has made several loans to certain officers and employees of the Company. Loans made in connection with the issuance of the Company’s Preferred Shares or common stock have been recognized in stock subscription receivables as a reduction of equity.

In March 2014, the Company entered into agreements with certain executive officers to repurchase an aggregate of 109,779 shares of common stock (48,516 shares pre-stock split) at a price of $11.85 per share ($26.80 per share pre-stock split), for a total purchase price of $1.3 million. Included among the repurchased shares were 31,707 shares of common stock (14,014 shares pre-stock split) 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 (48,516 stock options pre-stock split) to purchase shares at an exercise price of $11.85 per share ($26.80 per share pre-stock split), including 78,072 fully vested options (34,502 options pre-stock split) and 31,707 options (14,014 options pre-stock split) subject to time-based or market condition-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 $533,000 for the three months ending March 31, 2014.

As of March 31, 2014 and December 30, 2013, the Company had stock subscription receivables of $140,000, and $1.2 million, respectively.

Notes receivable (see Note 6—Notes Receivable)—On August 18, 2009, the Company obtained a note receivable from a third party in connection with the sale and refranchising of Company-owned stores. Subsequently, in March 2011 a member of the third party became an employee of the Company. The Company’s related party notes receivable for this transaction had an outstanding balance of $433,000 and $443,000 as of March 31, 2014 and December 30, 2013, respectively. Based on repayment terms modified in September 2013, the note matures in 2020 and bears interest at 9.0% annually.

Related Party Revenue—For the three months ended March 31, 2014, the Company was party to transactions to sell services to Project Pie, LLC, a cost-method investee. The Company recorded revenues of $39,000 for the three months ended March 31, 2014. Revenue from these transactions are recorded as Lease and other on the Condensed Consolidated Statements of Operations and Comprehensive Income.

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Note 16—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 franchise stores in the United States and derives its revenues from franchise and development fees and the collection of franchise royalties from the Company's franchise owners located 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 the collection of franchise royalties located outside the United States.

The following tables summarize information on profit or loss and assets for each of our reportable segments (in thousands):

	Three Months Ended	
	March 31, 2014	April 1, 2013
Revenues		
Domestic Franchise	$13,047	$10,402
Domestic Company Stores	12,018	9,166
International	52	25
Other	—	—
Total	$25,117	$19,593
Segment Operating Income (Loss)		
Domestic Franchise	$5,994	$4,523
Domestic Company Stores	520	90
International	(104)	(49)
Other	(1,810)	(793)
Total	$4,600	$3,771

	March 31, 2014	December 30, 2013
Total Assets		
Domestic Franchise	$145,994	$139,471
Domestic Company Stores	28,046	29,489
International	533	515
Other (*)	119,827	119,375
Total	$294,400	$288,850
Elimination of intersegment assets:		
Intercompany note	(21,690)	(21,690)
Intercompany receivables	(9,410)	(2,658)
Total Consolidated	$263,300	$264,502

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

Note 17—Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. The Company recognizes in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing the financial statements. The Company's financial statements do not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet

date and before financial statements are issued.
On May 7, 2014, the Company completed 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 $55.8 million from this transaction after estimated offering fees and expenses. The net proceeds were used to repay $55.5 million of the Company's loans

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outstanding under the Company's senior secured credit facility after which the Company will have $112.5 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. The total liquidation preference on the Preferred Shares at the time of conversion was $64.3 million. After such conversion and before the shares were sold in the IPO, the Company had 11,134,070 common shares outstanding. As part of the IPO, the Company increased its authorized shares from 3,000,000 shares of common stock, $0.01 par value per share, to 200,000,000 shares of common stock, $0.01 par value per share. The Company also authorized the issuance of 15,000,000 shares of preferred stock, $0.01 par value per share, with no shares outstanding.

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. Concurrent with the stock split, the Company adjusted the number of shares subject to, and the exercise price of, its outstanding stock option awards under the 2010 Plan such that the holders of the options are in the same economic position both before and after the stock split. As a result of the stock split, all previously reported share amounts, including options in these unaudited condensed consolidated financial statements and accompanying notes, have been retrospectively restated to reflect the stock split.

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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 consolidated financial statements and related notes in Item 1 and with the audited consolidated financial statements and the related notes included in the Registration Statement. 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 2014 and 2013 are 52-week periods ending on December 29, 2014 and December 30, 2013, 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 “Forward-Looking Statements,” “Risk Factors” and elsewhere in our Registration Statement. 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. These statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “plan,” “intend,” “believe,” “may,” “should,” “can have,” “likely” and other word 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 “Risk Factors” and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Registration Statement. 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 the performance projected in 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. We were founded in 1981 and have grown our footprint to a total of 1,429 system-wide stores as of March 31, 2014. The Papa Murphy’s experience is different from traditional pizza restaurants. Our customers:

CREATE their fresh customized pizza with high-quality ingredients in our stores or online;

TAKE their fresh pizza home; and

BAKE their pizza fresh in their ovens, at their convenience, for a home-cooked meal served hot.

We have been repeatedly rated the #1 pizza chain in the United States by multiple third-party consumer studies. In 2014, we were rated #1 in the Pizza Category by Market Force Information, including the top spot in food quality, healthy food, and friendly service. In 2013, 2012 and 2011, we were rated the #1 pizza chain overall by Nation’s Restaurant News, and in 2012, 2011 and 2010, we were rated the #1 pizza chain by Zagat. Compared to broader restaurant chain competition, we were also recognized by Technomic in 2013 as the #1 chain overall among all restaurants and all food categories, by Nation’s Restaurant News in 2013 and 2012 as one of the Top 5 Overall limited service restaurant chains across all food categories, and by Zagat in 2012 as one of the Top 5 Overall fast food chains across all food categories.

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2014 Highlights
Restaurant Development
As of March 31, 2014, we had 1,405 stores in the United States (1,336 franchised stores and 69 company-owned stores), 20 in Canada and 4 in the United Arab Emirates. We expect the majority of our expansion will result from new franchise store openings, and we also plan to strategically expand our company-owned store base in select markets. Our domestic and international franchise owners opened 21 stores in the first quarter of 2014, including 19 in the United States.
Comparable Store Sales Growth
Comparable store sales increased by 3.3% at domestic restaurants, 3.1% at domestic franchise-owned restaurants, and 7.1% at company-owned restaurants in the first three months of 2014 compared to the first three months of 2013. The comparable store sales growth was primarily the result of a favorable product mix, an increase in average check and the result of favorable holiday shifts including 2013 New Year's Eve falling in the first week of 2014 compared to the 2012 New Year's Eve falling in the last week of 2012, and the Easter holiday falling in the second quarter of 2014, instead of the first quarter as in 2013. Most of our stores are closed on Easter day.
Common Stock Repurchases
In March 2014, we repurchased an aggregate of 109,779 shares of common stock from certain of our executive officers, including an aggregate of 31,707 shares of common stock for which vesting terms were accelerated in connection with the repurchase. We repurchased the shares at a price of $11.85 per share, the then-current fair market value of our common stock.

Recent Developments
Initial Public Offering
On May 7, 2014, we completed the IPO of 5,833,333 shares of common stock at a price to the public of $11.00 per share. We received net proceeds from the offering of approximately $55.8 million from this transaction after estimated offering fees and expenses. The net proceeds were used to repay $55.5 million of our loans outstanding under our senior secured credit facility after which we will have $112.5 million outstanding under the facility with the revolver undrawn.
Immediately prior to the IPO, we amended and restated our certificate of incorporation to reflect the automatic conversion of all outstanding Preferred Shares to 3,054,318 shares of common stock. The total liquidation preference on the Preferred Shares at the time of conversion was $64.3 million. After such conversion and before the shares were sold in the IPO, we had 11,134,070 common shares outstanding. As part of the IPO, we increased our authorized shares from 3,000,000 shares of common stock, $0.01 par value per share, to 200,000,000 shares of common stock, $0.01 par value per share. We also authorized the issuance of 15,000,000 shares of preferred stock, $0.01 par value per share, with no shares outstanding.
In connection with the IPO, on May 1, 2014, we amended our certificate of incorporation to effect a 2.2630 for 1 stock split of our common stock. Concurrent with the stock split, we adjusted the number of shares subject to, and the exercise price of, our outstanding stock option awards under the 2010 Plan such that the holders of the options are in the same economic position both before and after the stock split. As a result of the stock split, all previously reported share amounts, including options in these unaudited condensed consolidated financial statements and accompanying notes, have been retrospectively restated to reflect the stock split. After the conversion of our Preferred Shares and the stock split but before the shares were sold in the IPO, we had 11,134,070 common shares outstanding.

Our Segments
We operate in three business segments: Domestic Franchise, Domestic Company Stores and International. Our Domestic Franchise segment consists of our domestic franchise 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 franchise stores. The following table sets forth our revenues, operating income and depreciation and amortization for each of our

segments for the periods presented:

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	Three Months Ended	
	March 31, 2014	April 1, 2013
	(dollars in thousands)	
Revenues		
Domestic Franchise	$13,047	$10,402
Domestic Company Stores	12,018	9,166
International	52	25
Total	$25,117	$19,593
Operating Income		
Domestic Franchise	$5,994	$4,523
Domestic Company Stores	520	90
International	(104)	(49)
Other [1]	(1,810)	(793)
Total	$4,600	$3,771
Depreciation and Amortization		
Domestic Franchise	$1,169	$1,191
Domestic Company Stores	665	500
International	7	8
Total	$	