

PAPA JOHNS INTERNATIONAL INC

Form 10-Q

August 05, 2014

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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, 2014

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.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

61-1203323
(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
Non-accelerated filer

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

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At July 29, 2014, there were outstanding 40,926,449 shares of the registrant's common stock, par value \$0.01 per share.

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Table of Contents**PART 1. FINANCIAL INFORMATION****Item 1. Financial Statements****Papa John's International, Inc. and Subsidiaries****Condensed Consolidated Balance Sheets**

(In thousands, except per share amounts)	June 29, 2014 (Unaudited)	December 29, 2013
Assets		
Current assets:		
Cash and cash equivalents	\$ 19,971	\$ 13,670
Accounts receivable, net	48,377	53,203
Notes receivable, net	5,862	3,566
Inventories	31,895	23,035
Deferred income taxes	7,673	8,004
Prepaid expenses	14,156	14,336
Other current assets	9,646	9,226
Total current assets	137,580	125,040
Property and equipment, net	218,448	212,097
Notes receivable, less current portion, net	11,534	13,239
Goodwill	82,106	79,391
Other assets	35,532	34,524
Total assets	\$ 485,200	\$ 464,291
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 33,719	\$ 35,653
Income and other taxes payable	5,824	4,401
Accrued expenses and other current liabilities	54,468	57,807
Total current liabilities	94,011	97,861
Deferred revenue	5,579	5,827
Long-term debt	210,000	157,900
Deferred income taxes	12,928	14,660
Other long-term liabilities	45,644	42,835
Total liabilities	368,162	319,083
Redeemable noncontrolling interests	8,433	7,024
Stockholders' equity:		
Preferred stock (\$0.01 par value per share; no shares issued)		
Common stock (\$0.01 par value per share; issued 43,152 at June 29, 2014 and 42,796 at December 29, 2013)	432	428
Additional paid-in capital	139,705	137,552
Accumulated other comprehensive income	2,765	2,463
Retained earnings	66,944	41,297
Treasury stock (2,297 shares at June 29, 2014 and 1,129 shares at December 29, 2013, at cost)	(101,830)	(44,066)

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Total stockholders' equity, net of noncontrolling interests	108,016	137,674
Noncontrolling interests in subsidiaries	589	510
Total stockholders' equity	108,605	138,184
Total liabilities, redeemable noncontrolling interests and stockholders' equity	\$ 485,200	\$ 464,291

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		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
North America revenues:				
Domestic Company-owned restaurant sales	\$ 170,000	\$ 155,153	\$ 348,193	\$ 313,051
Franchise royalties	20,983	20,230	43,597	40,963
Franchise and development fees	132	219	276	765
Domestic commissary sales	150,581	140,003	314,628	283,897
Other sales	13,595	12,444	26,345	25,051
International revenues:				
Royalties and franchise and development fees	6,317	5,391	12,096	10,458
Restaurant and commissary sales	19,256	15,746	37,106	30,605
Total revenues	380,864	349,186	782,241	704,790
Costs and expenses:				
Domestic Company-owned restaurant expenses:				
Cost of sales	42,030	37,825	87,186	74,898
Salaries and benefits	45,805	42,053	93,388	85,325
Advertising and related costs	15,354	14,677	31,610	29,470
Occupancy costs	9,446	8,939	18,757	17,650
Other restaurant operating expenses	25,220	22,431	50,507	45,176
Total domestic Company-owned restaurant expenses	137,855	125,925	281,448	252,519
Domestic commissary expenses:				
Cost of sales	118,470	107,676	247,394	218,599
Salaries and benefits	6,847	6,084	13,871	12,100
Other commissary operating expenses	16,215	15,185	32,070	30,646
Total domestic commissary expenses	141,532	128,945	293,335	261,345
Other operating expenses	13,221	11,132	24,652	22,584
International restaurant and commissary expenses	15,876	12,983	30,761	25,636
General and administrative expenses	33,562	33,126	70,528	66,284
Other general expenses	1,964	1,597	3,497	2,782
Depreciation and amortization	9,855	8,530	19,019	17,067
Total costs and expenses	353,865	322,238	723,240	648,217
Operating income	26,999	26,948	59,001	56,573
Net interest (expense) income	(763)	(340)	(1,355)	332
Income before income taxes	26,236	26,608	57,646	56,905
Income tax expense	8,397	8,563	19,266	18,541
Net income before attribution to noncontrolling interests	17,839	18,045	38,380	38,364
Income attributable to noncontrolling interests	(1,091)	(895)	(2,321)	(1,908)
Net income attributable to the Company	\$ 16,748	\$ 17,150	\$ 36,059	\$ 36,456
Calculation of income for earnings per share:				
Net income attributable to the Company	\$ 16,748	\$ 17,150	\$ 36,059	\$ 36,456
Increase in noncontrolling interest redemption value	(31)		(39)	
Net income attributable to participating securities	(81)		(218)	
Net income attributable to common shareholders	\$ 16,636	\$ 17,150	\$ 35,802	\$ 36,456
Basic earnings per common share	\$ 0.40	\$ 0.39	\$ 0.86	\$ 0.83

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Diluted earnings per common share	\$	0.40	\$	0.39	\$	0.85	\$	0.81
Basic weighted average common shares outstanding		41,225		43,484		41,501		43,996
Diluted weighted average common shares outstanding		41,970		44,500		42,332		45,086
Dividends declared per common share	\$	0.125	\$		\$	0.250	\$	

See accompanying notes.

Table of Contents**Papa John's International, Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income****(Unaudited)**

(In thousands)	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Net income before attribution to noncontrolling interests	\$ 17,839	\$ 18,045	\$ 38,380	\$ 38,364
Other comprehensive income (loss), before tax:				
Foreign currency translation adjustments	959	(586)	926	(1,721)
Interest rate swaps (1)	(404)	190	(447)	73
Other comprehensive income (loss), before tax	555	(396)	479	(1,648)
Income tax effect:				
Foreign currency translation adjustments	(355)	217	(343)	637
Interest rate swaps (2)	149	(71)	165	(27)
Income tax effect	(206)	146	(178)	610
Other comprehensive income (loss), net of tax	349	(250)	301	(1,038)
Comprehensive income before attribution to noncontrolling interests	18,188	17,795	38,681	37,326
Comprehensive income, redeemable noncontrolling interests	(1,086)	(895)	(2,341)	(1,908)
Comprehensive (loss) income, nonredeemable noncontrolling interests	(5)		20	
Comprehensive income attributable to the Company	\$ 17,097	\$ 16,900	\$ 36,360	\$ 35,418

(1) Amounts reclassified out of accumulated other comprehensive income (AOCI) into net interest (expense) income included \$250 and \$499 for the three and six months ended June 29, 2014, respectively and \$44 and \$88 for the three and six months ended June 30, 2013, respectively.

(2) The income tax effects of amounts reclassified out of AOCI into net interest (expense) income were \$93 and \$185 for the three and six months ended June 29, 2014, respectively and \$16 and \$32 for the three and six months ended June 30, 2013, respectively.

See accompanying notes.

Table of Contents**Papa John's International, Inc. and Subsidiaries****Consolidated Statements of Cash Flows****(Unaudited)**

(In thousands)	Six Months Ended	
	June 29, 2014	June 30, 2013
Operating activities		
Net income before attribution to noncontrolling interests	\$ 38,380	\$ 38,364
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for uncollectible accounts and notes receivable	936	780
Depreciation and amortization	19,019	17,067
Deferred income taxes	6,298	8,256
Stock-based compensation expense	3,612	3,784
Excess tax benefit on equity awards	(7,890)	(3,803)
Other	2,270	694
Changes in operating assets and liabilities, net of acquisitions:		
Accounts receivable	3,400	496
Inventories	(7,295)	456
Prepaid expenses	180	2,000
Other current assets	(152)	(37)
Other assets and liabilities	(17)	(1,954)
Accounts payable	(1,934)	(3,896)
Income and other taxes payable	1,423	(9,022)
Accrued expenses and other current liabilities	(3,970)	(5,870)
Deferred revenue	305	(83)
Net cash provided by operating activities	54,565	47,232
Investing activities		
Purchases of property and equipment	(26,239)	(25,493)
Loans issued	(2,642)	(3,103)
Repayments of loans issued	1,880	2,908
Acquisitions, net of cash acquired	(3,179)	
Other	3	319
Net cash used in investing activities	(30,177)	(25,369)
Financing activities		
Net proceeds on line of credit facility	52,100	44,983
Cash dividends paid	(10,404)	
Excess tax benefit on equity awards	7,890	3,803
Tax payments for equity award issuances	(7,498)	(1,841)
Proceeds from exercise of stock options	3,361	3,696
Acquisition of Company common stock	(63,304)	(58,806)
Contributions from noncontrolling interest holders	100	450
Distributions to noncontrolling interest holders	(600)	(1,750)
Other	293	(468)
Net cash used in financing activities	(18,062)	(9,933)
Effect of exchange rate changes on cash and cash equivalents	(25)	(90)
Change in cash and cash equivalents	6,301	11,840
Cash and cash equivalents at beginning of period	13,670	16,396
Cash and cash equivalents at end of period	\$ 19,971	\$ 28,236

See accompanying notes.

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Papa John's International, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

June 29, 2014

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 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 six months ended June 29, 2014 are not necessarily indicative of the results that may be expected for the fiscal year ended December 28, 2014. 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, and our) for the year ended December 29, 2013.

2. Significant Accounting Policies

Reclassifications

Certain prior year amounts in the condensed consolidated statements of income have been reclassified to conform to the current year presentation, which had no effect on current or previously reported net income.

Noncontrolling Interests

Papa John's has joint ventures in which there are noncontrolling interests, including the following as of June 29, 2014 and June 30, 2013:

Number of Restaurants	Restaurant Locations	Papa John's Ownership	Noncontrolling Interest Ownership
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June 29, 2014

Star Papa, LP	81	Texas	51%	49%
Colonel s Limited, LLC	52	Maryland and Virginia	70%	30%
PJ Minnesota, LLC	34	Minnesota	80%	20%
PJ Denver, LLC	25	Colorado	60%	40%

June 30, 2013

Star Papa, LP	78	Texas	51%	49%
Colonel s Limited, LLC	52	Maryland and Virginia	70%	30%
PJ Minnesota, LLC	31	Minnesota	80%	20%
PJ Denver, LLC	24	Colorado	60%	40%

We are required to report 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.

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The income before income taxes attributable to the joint ventures for the three and six months ended June 29, 2014 and June 30, 2013 was as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Papa John's International, Inc.	\$ 1,744	\$ 1,284	\$ 3,592	\$ 2,792
Noncontrolling interests	1,091	895	2,321	1,908
Total income before income taxes	\$ 2,835	\$ 2,179	\$ 5,913	\$ 4,700

The following summarizes the redemption feature, location within the condensed consolidated balance sheets and the value at which the noncontrolling interests are recorded for each joint venture as of June 29, 2014:

Joint Venture	Redemption Feature	Location within the Condensed Consolidated Balance Sheets	Recorded Value
Colonel's Limited, LLC	Mandatorily redeemable	Other long-term liabilities	Redemption value
Star Papa, LP	Redeemable	Temporary equity	Carrying value
PJ Denver, LLC	Redeemable	Temporary equity	Redemption value
PJ Minnesota, LLC	No redemption feature	Permanent equity	Carrying value

The Colonel's Limited, LLC agreement contains a mandatory redemption clause and, accordingly, the Company has recorded this noncontrolling interest as a liability at its redemption value in other long-term liabilities. The redemption value is adjusted at each reporting date and any change is recorded in interest expense. We recorded interest income of \$48,000 and interest expense of \$36,000 in the second quarter of 2014 and 2013, respectively, and interest income of \$21,000 and \$773,000 in the first six months of 2014 and 2013 respectively. The redemption value was \$11.1 million as of June 29, 2014 and \$10.8 million as of December 29, 2013.

The noncontrolling interest holders of two other joint ventures have the option to require the Company to purchase their interests. Since redemption of the noncontrolling interests is outside of the Company's control, the noncontrolling interests are presented in the caption Redeemable noncontrolling interests in the condensed consolidated balance sheets and include the following joint ventures:

- The Star Papa, LP agreement contains a redemption feature that is not currently redeemable, but it is probable to become redeemable in the future. Due to specific valuation provisions contained in the agreement, this noncontrolling interest has been recorded at its carrying value.
- The PJ Denver, LLC agreement contains a redemption feature that is currently redeemable and, therefore, this noncontrolling interest has been recorded at its current redemption value. The change in redemption value is recorded as an adjustment to Redeemable noncontrolling interests and Retained earnings in the condensed consolidated balance sheets.

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The following summarizes changes in these redeemable noncontrolling interests (in thousands):

Balance at December 29, 2013	\$	7,024
Net income		1,370
Change in redemption value		39
Balance at June 29, 2014	\$	8,433

We have a fourth joint venture, PJ Minnesota, LLC, that had a redemption feature until a contract amendment removed the redemption feature in the fourth quarter of 2013. The noncontrolling interest was reclassified from

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temporary equity to Stockholders' equity in the condensed consolidated balance sheet at December 29, 2013, at carrying value.

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 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 June 29, 2014, we had a net deferred tax liability of approximately \$5.3 million.

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 fair value of our notes receivable net of allowances also approximates carrying 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.

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Our financial assets and liabilities that were measured at fair value on a recurring basis as of June 29, 2014 and December 29, 2013 are as follows (in thousands):

	Carrying Value	Level 1	Fair Value Measurements		Level 3
			Level 2		
<u>June 29, 2014</u>					
Financial assets:					
Cash surrender value of life insurance policies					
(a)	\$ 17,613	\$ 17,613	\$		\$
Interest rate swap (b)	41			41	
Financial liabilities:					
Interest rate swap (b)	584			584	
<u>December 29, 2013</u>					
Financial assets:					
Cash surrender value of life insurance policies					
(a)	\$ 16,798	\$ 16,798	\$		\$
Financial liabilities:					
Interest rate swap (b)	76			76	

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

(b) The fair values 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 six months ended June 29, 2014.

Variable Interest Entities

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, we determined that consolidation is not appropriate.

Recent Accounting Pronouncement

In May 2014, the Financial Accounting Standards Board issued Revenue from Contracts with Customers (Accounting Standards update 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 today's 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 the new requirements in the first quarter of 2017. We are currently evaluating the impact of the new requirements on our consolidated financial statements. We currently do not believe the impact will be significant.

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In the fourth quarter of 2013, we completed a two-for-one stock split of our outstanding shares in the form of a stock dividend. The stock dividend was distributed on December 27, 2013 with approximately 21.0 million shares of stock distributed. In conjunction with the stock split, we also retired shares held in treasury. The per-share and share amounts for 2013 in the accompanying condensed consolidated financial statements and notes to the financial statements have been adjusted to reflect the stock split.

4. 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 increase in the redemption value for the noncontrolling interest of PJ Denver, LLC reduces income attributable to common shareholders.

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

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Basic earnings per common share:				
Net income attributable to the Company	\$ 16,748	\$ 17,150	\$ 36,059	\$ 36,456
Increase in noncontrolling interest redemption value	(31)		(39)	
Net income attributable to participating securities	(81)		(218)	
Net income attributable to common shareholders	\$ 16,636	\$ 17,150	\$ 35,802	\$ 36,456
Weighted average common shares outstanding	41,225	43,484	41,501	43,996
Basic earnings per common share	\$ 0.40	\$ 0.39	\$ 0.86	\$ 0.83
Diluted earnings per common share:				
Net income attributable to common shareholders	\$ 16,636	\$ 17,150	\$ 35,802	\$ 36,456
Weighted average common shares outstanding	41,225	43,484	41,501	43,996

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Dilutive effect of outstanding equity awards (a)	745	1,016	831	1,090
Diluted weighted average common shares outstanding	41,970	44,500	42,332	45,086
Diluted earnings per common share	\$ 0.40	\$ 0.39	\$ 0.85	\$ 0.81

(a) Excludes 284 and 176 awards for the three and six months ended June 29, 2014 and 218 and 151 awards for the three and six months ended June 30, 2013, as the effect of including such awards would have been antidilutive.

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5. Debt

Our debt is comprised entirely of a revolving line of credit. The outstanding balance was \$210.0 million as of June 29, 2014 and \$157.9 million as of December 29, 2013.

In September 2010, we entered into a five-year, \$175 million unsecured revolving credit facility, which was amended in November 2011 to extend the maturity date to November 30, 2016. On April 30, 2013, we amended and restated our revolving credit facility to increase the amount available for borrowing thereunder to \$300 million and extend the maturity date to April 30, 2018. The interest rate charged on outstanding balances is LIBOR plus 75 to 175 basis points. The commitment fee on the unused balance ranges from 15 to 25 basis points. The remaining availability under the revolving credit facility, reduced for outstanding letters of credit, was approximately \$67.5 million as of June 29, 2014.

The revolving credit facility contains customary affirmative and negative covenants, including financial covenants requiring the maintenance of specified fixed charges and leverage ratios. At June 29, 2014, we were in compliance with these covenants.

In August 2011, we entered into an interest rate swap agreement that resulted in a fixed rate of 0.53%, instead of the variable rate of LIBOR, with a notional amount of \$50 million and a maturity date of August 2013. On December 31, 2012, we amended our interest rate swap agreement to extend the maturity date to December 30, 2015. The amendment resulted in a change to the fixed rate (to 0.56% from 0.53%) but did not impact the notional amount of the interest rate swap agreement. On July 30, 2013, we terminated the \$50 million swap and entered into a new \$75 million swap. The new swap has an interest rate of 1.42% and a maturity date of April 30, 2018, which coincides with the maturity date of our revolving credit facility. The termination of the previous swap did not have a material impact on our 2013 results. In May 2014, we entered into a \$50 million forward interest rate swap with an interest rate of 1.36%, an effective date of December 30, 2014 and a maturity date of April 30, 2018.

Our swaps are derivative instruments that are designated as cash flow hedges because the swaps provide a hedge against the effects of rising interest rates on borrowings. The effective portion of the gain or loss on the swaps is reported as a component of accumulated other comprehensive income and reclassified into earnings in the same period or periods during which the swaps affect earnings. Gains or losses on the swaps representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. Amounts payable or receivable under the swaps are accounted for as adjustments to interest expense. As of June 29, 2014, the swaps are highly effective cash flow hedges with no ineffectiveness for the three- and six-month periods ended June 29, 2014.

The weighted average interest rates for our revolving credit facility, including the impact of the previously mentioned swap agreement, were 1.7% and 1.6% for the three and six months ended June 29, 2014, respectively. Interest paid, including payments made or received under the swap, was \$853,000 and \$424,000 for the three months ended June 29, 2014 and June 30, 2013, respectively, and \$1.6 million and \$802,000 for the six months ended June 29, 2014 and June 30, 2013, respectively. As of June 29, 2014, the portion of the \$543,000 net interest rate swap liability that would be reclassified into earnings during the next twelve months as interest expense approximates \$142,000.

6. Litigation

Litigation

The Company is involved in a number of lawsuits, claims, investigations and proceedings, including those specifically identified below, consisting of intellectual property, employment, consumer, commercial and other matters arising in the ordinary course of business. In accordance with ASC 450, *Contingencies*, the Company has made accruals with respect to these matters, where appropriate, which are reflected in the Company's financial statements. We review these provisions at least quarterly and adjust these provisions to reflect the impact of

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negotiations, settlements, rulings, advice of legal counsel and other information and events pertaining to a particular case.

Perrin v. Papa John's International, Inc. and Papa John's USA, Inc. is a conditionally certified collective action filed in August 2009 in the United States District Court, Eastern District of Missouri, alleging that delivery drivers were not reimbursed for mileage and expenses in accordance with the Fair Labor Standards Act. Approximately 3,900 drivers out of a potential class size of 28,800 have opted into the action. Additionally, in late December 2013, the District Court granted a motion for class certification in five additional states, which will add approximately 15,000 plaintiffs to the case.

We intend to vigorously defend against all claims in this lawsuit. However, given the inherent uncertainties of litigation, the outcome of this case cannot be predicted and the amount of any potential loss cannot be reasonably estimated. A negative outcome in this case could have a material adverse effect on the Company.

7. Segment Information

We have five reportable segments: domestic Company-owned restaurants, domestic commissaries, North America franchising, international operations, and all other units.

The domestic Company-owned restaurant segment consists of the operations of all domestic (domestic is defined as contiguous United States) Company-owned restaurants and derives its revenues principally from retail sales of pizza and side items, such as breadsticks, cheesesticks, chicken poppers, chicken wings, cookie and dessert pizza and soft drinks to the general public. The domestic commissary segment consists of the operations of our regional dough production and product distribution centers and derives its revenues principally from the sale and distribution of food and paper products to domestic Company-owned and franchised restaurants. The North America franchising segment consists of our franchise sales and support activities and derives its revenues from sales of franchise and development rights and collection of royalties from our franchisees located in the United States and Canada. The international operations segment principally consists of Company-owned restaurants in China and distribution sales to franchised Papa John's restaurants located in the United Kingdom, Mexico and China and our franchise sales and support activities, which derive revenues from sales of franchise and development rights and the collection of royalties from our international franchisees. International franchisees are defined as all franchise operations outside of the United States and Canada. All other business units that do not meet the quantitative thresholds for determining reportable segments, which are not operating segments, we refer to as our all other segment, which consists of operations that derive revenues from the sale, principally to Company-owned and franchised restaurants, of printing and promotional items, risk management services, and information systems and related services used in restaurant operations, including our point-of-sale system, online and other technology-based ordering platforms.

Generally, we evaluate performance and allocate resources based on profit or loss from operations before income taxes and intercompany eliminations. Certain administrative and capital costs are allocated to segments based upon predetermined rates or actual estimated resource usage. We account for intercompany sales and transfers as if the sales or transfers were to third parties and eliminate the activity in consolidation.

Our reportable segments are business units that provide different products or services. Separate management of each segment is required because each business unit is subject to different operational issues and strategies. No single external customer accounted for 10% or more of our

consolidated revenues.

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Our segment information is as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
Revenues from external customers:				
Domestic Company-owned restaurants	\$ 170,000	\$ 155,153	\$ 348,193	\$ 313,051
Domestic commissaries	150,581	140,003	314,628	283,897
North America franchising	21,115	20,449	43,873	41,728
International	25,573	21,137	49,202	41,063
All others	13,595	12,444	26,345	25,051
Total revenues from external customers	\$ 380,864	\$ 349,186	\$ 782,241	\$ 704,790
Intersegment revenues:				
Domestic commissaries	\$ 51,592	\$ 46,115	\$ 106,313	\$ 92,912
North America franchising	583	552	1,187	1,105
International	90	73	158	140
All others	8,087	3,318	11,817	6,486
Total intersegment revenues	\$ 60,352	\$ 50,058	\$ 119,475	\$ 100,643
Income (loss) before income taxes:				
Domestic Company-owned restaurants	\$ 10,651	\$ 8,175	\$ 23,936	\$ 19,131
Domestic commissaries	6,846	9,642	17,277	19,805
North America franchising	17,882	17,396	37,366	35,618
International	1,903	866	2,635	1,207
All others	(442)	1,153	148	1,812
Unallocated corporate expenses	(10,702)	(10,413)	(23,163)	(19,931)
Elimination of intersegment losses (profits)	98	(211)	(553)	(737)
Total income before income taxes	\$ 26,236	\$ 26,608	\$ 57,646	\$ 56,905
Property and equipment:				
Domestic Company-owned restaurants	\$ 203,632			
Domestic commissaries	105,711			
International	27,711			
All others	43,113			
Unallocated corporate assets	161,786			
Accumulated depreciation and amortization	(323,505)			
Net property and equipment	\$ 218,448			

Table of Contents**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Overview**

Papa John's International, Inc. (referred to as the Company, Papa John's or in the first person notations of we, us and our) began operations in 1984. At June 29, 2014, there were 4,487 Papa John's restaurants (731 Company-owned and 3,756 franchised) operating in all 50 states and in 37 international countries and territories. Our revenues are principally derived from retail sales of pizza and other food and beverage products to the general public by Company-owned restaurants, franchise royalties, sales of franchise and development rights, sales to franchisees of food and paper products, printing and promotional items, risk management services, and information systems and related services used in their operations.

The results of operations are based on the preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States (GAAP). The preparation of consolidated financial statements requires management to select accounting policies for critical accounting areas and make estimates and assumptions that affect the amounts reported in the consolidated financial statements. Significant changes in assumptions and/or conditions in our critical accounting policies could materially impact the operating results. See Notes 1 and 2 of Notes to Condensed Consolidated Financial Statements for a discussion of the basis of presentation and the significant accounting policies.

Restaurant Progression

	Three Months Ended		Six Months Ended	
	June 29, 2014	June 30, 2013	June 29, 2014	June 30, 2013
North America Company-owned:				
Beginning of period	666	649	665	648
Opened	2	5	4	6
Closed	(1)		(2)	
Acquired from franchisees	5		5	
End of period	672	654	672	654
International Company-owned:				
Beginning of period	58	50	58	48
Opened	1	1	1	3
End of period	59	51	59	51
North America franchised:				
Beginning of period	2,615	2,572	2,621	2,556
Opened	28	32	49	63
Closed	(24)	(16)	(51)	(31)
Sold to Company	(5)		(5)	
End of period	2,614	2,588	2,614	2,588
International franchised:				
Beginning of period	1,101	926	1,084	911
Opened	46	43	69	69
Closed	(5)	(10)	(11)	(21)
End of period	1,142	959	1,142	959
Total restaurants - end of period	4,487	4,252	4,487	4,252

Table of ContentsFOCUS System

The Company is implementing a new, proprietary point-of-sale system (FOCUS) in substantially all domestic system-wide restaurants. As of June 29, 2014, we had installed FOCUS in 383 restaurants (369 Company-owned and 14 franchised), with the majority of the installations expected to occur by the end of 2014.

The costs related to implementing FOCUS are projected to decrease income before income taxes by approximately \$5.0 million in 2014, or an \$0.08 negative impact on diluted earnings per share, as compared to 2013. FOCUS had the following impact on our condensed consolidated statements of income for the three and six months ended June 29, 2014 (in thousands):

	Three Months June 29, 2014	Six Months June 29, 2014
Other sales (a)	\$ 123	\$ 135
Other operating expenses (b)	(462)	(651)
Depreciation and amortization (c)	(529)	(579)
Net decrease in income before income taxes	\$ (868)	\$ (1,095)
Diluted earnings per common share	\$ (0.01)	\$ (0.02)

-
- (a) Represents revenues for equipment installed at domestic franchised restaurants.
- (b) Includes cost of sales associated with equipment installed at franchised restaurants and other costs to support the rollout of the program.
- (c) Includes depreciation expense for both the capitalized software and for equipment installed at Company-owned restaurants.

Total income before income taxes and other measures excluding FOCUS system rollout costs included within this filing are not measures defined by GAAP. These non-GAAP measures should not be construed as substitutes for or better indicators of the company's performance than the company's GAAP results. Management believes presenting income before income taxes and other measures excluding the FOCUS system rollout costs is important for purposes of comparison to prior year results and analyzing each segment's operating results. In addition, management uses these non-GAAP measures to allocate resources and analyze trends and underlying operating performance of the Company.

As part of the rollout, we have partnered with a third party to offer a financing option for this system to our franchisees. The arrangement with the third party requires us to offer a guarantee for the loans. The term of these loans will be five years or less and will require us to perform under the guarantee when a franchisee has a late payment in excess of 60 days. The guarantee is limited to the greater of 10% of all loans or 100% of all loans that have higher risk profiles. Higher risk loan profiles are determined based on pre-established criteria including length of time in business, credit rating, and other factors. As part of this program, we have the ability to decline funding on higher risk loans.

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We will record a liability for the estimated fair value of the guarantee. As of June 29, 2014, we have no recorded liability as the FOCUS franchise rollout has just started.

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Results of Operations

Summary of Operating Results - Segment Review

Discussion of Revenues

Consolidated revenues were \$380.9 million for the three months ended June 29, 2014, an increase of \$31.7 million, or 9.1%, over the corresponding 2013 period. For the six months ended June 29, 2014, total revenues were \$782.2 million, an increase of \$77.5 million, or 11.0%, over the corresponding 2013 period. The increases in revenues for the three and six months ended June 29, 2014, were primarily due to the following:

- Domestic Company-owned restaurant sales increased \$14.8 million, or 9.6%, and \$35.1 million, or 11.2% for the three and six months ended June 29, 2014, respectively, primarily due to increases of 7.5% and 9.5% in comparable sales. Comparable sales represents the change in year-over-year sales for the same base of restaurants for the same fiscal periods.
- North America franchise royalty revenue increased approximately \$750,000, or 3.7%, and \$2.6 million or 6.4%, for the three and six months ended June 29, 2014, respectively, primarily due to increases of 5.4% and 7.2% in comparable sales, partially offset by increases in royalty incentives to franchisees for meeting certain development and performance targets.
- Domestic commissary sales increased \$10.6 million, or 7.6%, and \$30.7 million, or 10.8%, for the three and six months ended June 29, 2014, respectively, due to increases in the prices of certain commodities, primarily cheese, and increases in sales volumes for the six-month period.
- International royalties and franchise and development fees increased approximately \$900,000, or 17.2%, and \$1.6 million, or 15.7%, for the three and six months ended June 29, 2014, respectively, primarily due to increases in the number of restaurants and increases in comparable sales of 8.6% and 7.6%, calculated on a constant dollar basis.
- International restaurant and commissary sales increased \$3.5 million, or 22.3%, and \$6.5 million, or 21.2%, respectively, primarily due to increases in China Company-owned restaurant sales, due to increases in units, and increases in our United Kingdom commissary revenues, due to increases in units and higher comparable sales.

Discussion of Operating Results

Second quarter 2014 income before income taxes was \$26.2 million compared to \$26.6 million in the prior year comparable period, or a decrease of \$372,000, or 1.4%. Excluding FOCUS rollout costs of \$868,000, income before income taxes increased \$496,000, or 1.9%. Income before income taxes was \$57.6 million for the six months ended June 29, 2014, compared to \$56.9 million for the prior year comparable period, or an increase of \$741,000, or 1.3%. Excluding FOCUS rollout costs of \$1.1 million, income before income taxes increased \$1.8 million, or 3.2%. See the FOCUS System section for additional information.

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Income before income taxes is summarized in the following table on a reporting segment basis (in thousands):

	Three Months Ended			Six Months Ended		
	June 29, 2014	June 30, 2013	Increase (Decrease)	June 29, 2014	June 30, 2013	Increase (Decrease)
Domestic Company-owned restaurants	\$ 10,651	\$ 8,175	\$ 2,476	\$ 23,936	\$ 19,131	\$ 4,805
Domestic commissaries	6,846	9,642	(2,796)	17,277	19,805	(2,528)
North America franchising	17,882	17,396	486	37,366	35,618	1,748
International	1,903	866	1,037	2,635	1,207	1,428
All others	(442)	1,153	(1,595)	148	1,812	(1,664)
Unallocated corporate expenses	(10,702)	(10,413)	(289)	(23,163)	(19,931)	(3,232)
Elimination of intersegment losses (profits)	98	(211)	309	(553)	(737)	184
Total income before income taxes	\$ 26,236	\$ 26,608	\$ (372)	\$ 57,646	\$ 56,905	\$ 741
FOCUS system rollout costs (a)	868		868	1,095		1,095
Total income before income taxes, excluding FOCUS system rollout costs (b)	\$ 27,104	\$ 26,608	\$ 496	\$ 58,741	\$ 56,905	\$ 1,836

(a) See the FOCUS System section for additional information.

(b) Represents a measure that is not defined by accounting principles generally accepted in the United States (GAAP). See the FOCUS System section for additional information.

The decrease of \$372,000, or 1.4%, and increase of \$741,000, or 1.3%, including FOCUS rollout costs, for the three- and six-month periods, respectively, were primarily due to the following:

- **Domestic Company-owned Restaurant Segment.** Domestic Company-owned restaurants income before income taxes increased approximately \$2.5 million and \$4.8 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding prior year periods. The increases were primarily due to the 7.5% and 9.5% increases in comparable sales, partially offset by the impact of higher commodity costs. The market price for cheese averaged \$2.13 and \$2.17 per pound for the three- and six-month periods in 2014, compared to \$1.78 and \$1.72 per pound in the prior year comparable periods.

- **Domestic Commissary Segment.** Domestic commissaries income before income taxes decreased approximately \$2.8 million and \$2.5 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding prior year periods. The decrease for the three-month period was primarily due to a lower margin of approximately \$800,000, higher insurance claims costs of approximately \$1.1 million and higher costs associated with various ongoing commissary initiatives. The decrease for the six-month period was due to the previously mentioned higher costs, partially offset by incremental profits from higher sales. We manage commissary results on a full year basis and anticipate the 2014 full year profit margin will approximate 2013.

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- **North America Franchising Segment.** North America Franchising income before income taxes increased \$486,000 and \$1.7 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding prior year periods. The increases were primarily due to higher royalties from the 5.4% and 7.2% comparable sales, partially offset by the previously mentioned increases in royalty incentives.

- **International Segment.** Income before income taxes increased approximately \$1.0 million and \$1.4 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding prior year periods. The increases were primarily due to increases in units and comparable sales increases of 8.6% and 7.6%, which resulted in both higher royalties and increases in United Kingdom profits. These increases were partially offset by unfavorable results at our China Company-owned restaurant operations.

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• **All Others Segment.** The All Others reporting segment, which primarily includes our online and mobile ordering business and our wholly-owned print and promotions subsidiary, Preferred Marketing Solutions, decreased approximately \$1.6 million and \$1.7 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding prior year periods. The decreases were primarily due to higher infrastructure costs to support our digital ordering business and a lower margin at our print and promotions business from a discounted direct mail campaign provided to domestic franchised restaurants.

• **Unallocated Corporate Expenses.** Unallocated corporate expenses increased approximately \$300,000 and \$3.2 million for the three and six months ended June 29, 2014, respectively, compared to the corresponding 2013 periods. The components of unallocated corporate expenses were as follows (in thousands):

	Three Months Ended			Six Months Ended		
	June 29, 2014	June 30, 2013	Increase (Decrease)	June 29, 2014	June 30, 2013	Increase (Decrease)
General and administrative (a)	\$ 8,146	\$ 8,358	\$ (212)	\$ 18,475	\$ 17,045	\$ 1,430
Net interest expense (income) (b)	781	376	405	1,386	(283)	1,669
Depreciation	1,839	1,638	201	3,614	3,391	223
Other (income) expense	(502)	41	(543)	(895)	(222)	(673)
FOCUS system rollout costs (c)	438		438	583		583
Total unallocated corporate expenses	\$ 10,702	\$ 10,413	\$ 289	\$ 23,163	\$ 19,931	\$ 3,232

(a) The increase in unallocated general and administrative costs for the six-month period was primarily due to higher salaries and benefits and equity compensation costs.

(b) The increase in net interest expense (income) was primarily due to a higher average outstanding debt balance with a higher effective interest rate. Additionally, the 2013 six-month period included an approximate \$773,000 benefit from a decrease in the redemption value of a mandatorily redeemable noncontrolling interest in a joint venture.

(c) Includes depreciation expense for capitalized FOCUS software costs and other costs to support the rollout of the program.

Diluted earnings per share were as follows for the three and six months ended June 29, 2014 and June 30, 2013:

	Three Months Ended			Six Months Ended		
	June 29, 2014	June 30, 2013	Increase	June 29, 2014	June 30, 2013	Increase
Diluted earnings per share as reported (a)	\$ 0.40	\$ 0.39	\$ 0.01	\$ 0.85	\$ 0.81	\$ 0.04
FOCUS system rollout costs	0.01		0.01	0.02		0.02
Diluted earnings per share, excluding Focus system rollout costs (b)	\$ 0.41	\$ 0.39	\$ 0.02	\$ 0.87	\$ 0.81	\$ 0.06

- (a) Diluted earnings per share increased \$0.02 and \$0.05 for the three- and six-month periods, respectively, due to reductions in shares outstanding (a 5.7% reduction for the three-month period and a 6.1% reduction for the six-month period).
- (b) Represents a measure that is not defined by GAAP. See the FOCUS System section for additional information.

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Review of Consolidated Operating Results

Revenues. Domestic Company-owned restaurant sales were \$170.0 million for the three months ended June 29, 2014, compared to \$155.2 million for the same period in 2013, and \$348.2 million for the six months ended June 29, 2014, compared to \$313.1 million for the same period in 2013. The increases of \$14.8 million and \$35.1 million were primarily due to the previously mentioned increases of 7.5% and 9.5% in comparable sales and increases of 2.5% and 2.3% in equivalent units during the three and six months ended June 29, 2014, respectively.

Equivalent units represents the number of restaurants open at the beginning of a given period, adjusted for restaurants opened, closed, acquired or sold during the period on a weighted average basis.

North America franchise royalties were \$21.0 million and \$43.6 million for the three and six months ended June 29, 2014, respectively, representing increases of approximately \$750,000, or 3.7%, and \$2.6 million, or 6.4%, from the comparable periods in the prior year. The increases in royalties were primarily due the previously mentioned increases of 5.4% and 7.2% in comparable sales and increases of 1.1% and 1.5% in equivalent units during the three and six months ended June 29, 2014, partially offset by increases in royalty incentives for meeting certain development and performance targets. North America franchise sales increased 6.6% to \$496.7 million for the three months ended June 29, 2014, compared to \$466.2 million for the same period in 2013, and increased 8.5% to \$1.03 billion for the six months ended June 29, 2014, compared to \$946.3 million for the same period in 2013. Franchise restaurant sales are not included in Company revenues; however, our domestic royalty revenue is derived from these sales.

Average weekly sales for comparable units include restaurants that were open throughout the periods presented below. The comparable sales base for domestic Company-owned and North America franchised restaurants, respectively, includes restaurants acquired by the Company or divested to franchisees during the previous twelve months. Average weekly sales for non-comparable units include restaurants that were not open throughout the periods presented below and include non-traditional sites. Average weekly sales for non-traditional units not subject to continuous operations are calculated based upon actual days open.

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The comparable sales base and average weekly sales for 2014 and 2013 for domestic Company-owned and North America franchised restaurants consisted of the following:

	June 29, 2014	Three Months Ended	June 30, 2013
Company			