CARROLS RESTAURANT GROUP, INC.
Form 10-Q
November 09, 2016
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

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

For the quarterly period ended October 2, 2016

OR

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

Commission File Number: 001-33174

CARROLS RESTAURANT GROUP, INC.
(Exact name of Registrant as specified in its charter)

Delaware	16-1287774
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
968 James Street Syracuse, New York	13203
(Address of principal executive office)	(Zip Code)

Registrant’s telephone number, including area code: (315) 424-0513

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 ý No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý 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. (Check one):

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

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

As of November 7, 2016, Carrols Restaurant Group, Inc. had 35,835,800 shares of its common stock, $.01 par value, outstanding.

Table of Contents

CARROLS RESTAURANT GROUP, INC.
FORM 10-Q
QUARTER ENDED October 2, 2016

Table of Contents

PART I—FINANCIAL INFORMATION
ITEM 1—INTERIM CONSOLIDATED FINANCIAL STATEMENTS
CARROLS RESTAURANT GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands of dollars, except share and per share amounts)
(Unaudited)

	October 2, 2016	January 3, 2016
ASSETS		
Current assets:		
Cash	$10,137	$22,274
Trade and other receivables	7,595	6,161
Inventories	7,719	7,126
Prepaid rent	4,399	4,168
Prepaid expenses and other current assets	6,265	5,266
Total current assets	36,115	44,995
Property and equipment, net of accumulated depreciation of $246,686 and $226,140, respectively	251,618	220,114
Franchise rights, net of accumulated amortization of $92,270 and $87,869, respectively (Note 3)	127,017	118,881
Goodwill (Note 3)	21,804	20,438
Franchise agreements, at cost less accumulated amortization of $9,431 and $8,471, respectively	15,356	15,467
Favorable leases, net of accumulated amortization of $1,770 and $1,339, respectively (Note 3)	5,272	5,652
Other assets	1,843	1,709
Total assets	$459,025	$427,256
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term debt (Note 7)	$1,585	$1,435
Accounts payable	21,643	20,436
Accrued interest	6,675	2,672
Accrued payroll, related taxes and benefits	23,720	27,582
Accrued real estate taxes	4,993	5,117
Other liabilities	15,567	14,012
Total current liabilities	74,183	71,254
Long-term debt, net of current portion (Note 7)	212,317	202,042
Lease financing obligations	1,195	1,193
Deferred income—sale-leaseback of real estate (Note 6)	12,185	12,589
Accrued postretirement benefits	3,020	3,060
Unfavorable leases, net of accumulated amortization of $4,328 and $3,444, respectively (Note 3)	12,018	12,004
Other liabilities (Note 5)	18,471	17,115
Total liabilities	333,389	319,257
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, par value $.01; authorized 20,000,000 shares, issued and outstanding—100 shares	—	—
Voting common stock, par value $.01; authorized—100,000,000 shares, issued—35,835,800 and 35,508,660 shares, respectively, and outstanding—35,255,399 and 35,039,890 shares, respectively	353	350
Additional paid-in capital	140,707	139,083
Accumulated deficit	(14,948)	(30,958)

Accumulated other comprehensive loss	(335)	(335)
Treasury stock, at cost	(141)	(141)
Total stockholders’ equity	125,636	107,999
Total liabilities and stockholders’ equity	$459,025	$427,256

The accompanying notes are an integral part of these unaudited consolidated financial statements.
3

Table of Contents

CARROLS RESTAURANT GROUP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
THREE AND NINE MONTHS ENDED OCTOBER 2, 2016 AND SEPTEMBER 27, 2015
(In thousands of dollars)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Restaurant sales	$238,870	$ 217,676	$702,757	$ 629,948
Costs and expenses:				
Cost of sales	63,844	60,676	184,981	178,022
Restaurant wages and related expenses	75,678	67,116	221,306	197,135
Restaurant rent expense	16,081	14,106	48,077	43,101
Other restaurant operating expenses	37,606	34,261	110,611	100,407
Advertising expense	10,857	8,188	30,755	23,551
General and administrative (including stock-based compensation expense of $456, $367, $1,627 and $1,071, respectively)	13,000	11,764	40,561	36,263
Depreciation and amortization	12,070	9,418	34,613	29,216
Impairment and other lease charges (Note 4)	685	396	1,193	2,732
Other expense (income) (Note 13)	—	—	1,035	(126)
Total operating expenses	229,821	205,925	673,132	610,301
Income from operations	9,049	11,751	29,625	19,647
Interest expense	4,560	4,512	13,615	14,026
Loss on extinguishment of debt (Note 7)	—	—	—	12,635
Income (loss) before income taxes	4,489	7,239	16,010	(7,014)
Provision (benefit) for income taxes (Note 8)	—	—	—	—
Net income (loss)	$4,489	$ 7,239	$16,010	$ (7,014)
Basic and diluted net income (loss) per share (Note 12)	$0.10	$ 0.16	$0.35	$ (0.20)
Diluted weighted average common shares outstanding	44,855,778	44,678,514	44,892,188	34,930,326
Other comprehensive income (loss), net of tax:				
Net income (loss)	$4,489	$ 7,239	$16,010	$ (7,014)
Other comprehensive income (loss)	—	—	—	—
Comprehensive income (loss)	$4,489	$ 7,239	$16,010	$ (7,014)

The accompanying notes are an integral part of these unaudited consolidated financial statements.

Table of Contents

CARROLS RESTAURANT GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
NINE MONTHS ENDED OCTOBER 2, 2016 AND SEPTEMBER 27, 2015
(In thousands of dollars)
(Unaudited)

	Nine Months Ended October 2, 2016	September 27, 2015
Cash flows provided from operating activities:		
Net income (loss)	$ 16,010	$ (7,014)
Adjustments to reconcile net income (loss) to net cash provided from operating activities:		
Loss on disposals of property and equipment	14	252
Stock-based compensation	1,627	1,071
Impairment and other lease charges	1,193	2,732
Depreciation and amortization	34,613	29,216
Amortization of deferred financing costs	593	663
Amortization of deferred gains from sale-leaseback transactions	(1,348)	(1,953)
Loss on extinguishment of debt	—	12,635
Change in refundable income taxes	—	2,416
Changes in other operating assets and liabilities	(1,863)	15,567
Net cash provided from operating activities	50,839	55,585
Cash flows used for investing activities:		
Capital expenditures:		
New restaurant development	(5,857)	(556)
Restaurant remodeling	(45,312)	(27,807)
Other restaurant capital expenditures	(12,037)	(7,367)
Corporate and restaurant information systems	(2,181)	(1,801)
	(65,387)	(37,531)

Total capital expenditures		
Acquisition of restaurants, net of cash acquired	(33,407)	(1,657)
Proceeds from sale of other assets	—	534
Properties purchased for sale-leaseback	(4,096)	(3,575)
Proceeds from sale-leaseback transactions	29,394	3,136
Proceeds from insurance recoveries	1,216	—
Net cash used for investing activities	(72,280)	(39,093)
Cash flows provided from financing activities		
Proceeds from issuance of 8% senior secured second lien notes	—	200,000
Redemption of 11.25% senior secured second lien notes	—	(159,771)
Borrowings under senior credit facility	50,250	—
Repayments under senior credit facility	(39,750)	—
Principal payments on capital leases	(1,094)	(945)
Financing costs associated with issuance of debt	(102)	(5,164)
Net cash provided from financing activities	9,304	34,120
Net increase (decrease) in cash	(12,137)	50,612
Cash, beginning of period	22,274	21,221
Cash, end of period	$ 10,137	$ 71,833
Supplemental disclosures:		
Interest paid on long-term debt	$ 8,941	$ 8,565
Interest paid on lease financing obligations	$ 78	$ 77
Accruals for capital expenditures	$ 3,468	$ 3,084
Income taxes refunded (paid)	$ (3)	$ 2,416
	$ 553	$ —

Capital lease obligations
acquired or incurred

The accompanying notes are an integral part of these unaudited consolidated financial statements.
5

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS
(in thousands of dollars except share and per share amounts)

1. Basis of Presentation

Business Description. At October 2, 2016 Carrols Restaurant Group, Inc. ("Carrols Restaurant Group") operated, as franchisee, 734 restaurants under the trade name "Burger King ®" in 16 Northeastern, Midwestern and Southeastern states.

Basis of Consolidation. Carrols Restaurant Group is a holding company and conducts all of its operations through its wholly-owned subsidiary, Carrols Corporation ("Carrols") and Carrols' wholly-owned subsidiary, Carrols LLC, a Delaware limited liability company. The unaudited consolidated financial statements presented herein include the accounts of Carrols Restaurant Group and its wholly-owned subsidiary Carrols.

Unless the context otherwise requires, Carrols Restaurant Group, Carrols and Carrols LLC are collectively referred to as the "Company." All intercompany transactions have been eliminated in consolidation.

Fiscal Year. The Company uses a 52-53 week fiscal year ending on the Sunday closest to December 31. The fiscal year ended January 3, 2016 contained 53 weeks. The three and nine months ended October 2, 2016 and September 27, 2015 each contained thirteen and thirty-nine weeks, respectively. The 2016 fiscal year will end January 1, 2017 and will contain 52 weeks.

Basis of Presentation. The accompanying unaudited consolidated financial statements for the three and nine months ended October 2, 2016 and September 27, 2015 have been prepared without an audit, pursuant to the rules and regulations of the Securities and Exchange Commission and do not include certain of the information and the footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all normal and recurring adjustments considered necessary for a fair presentation of such unaudited consolidated financial statements have been included. The results of operations for the three and nine months ended October 2, 2016 and September 27, 2015 are not necessarily indicative of the results to be expected for the full year.

These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the year ended January 3, 2016. The January 3, 2016 consolidated balance sheet data is derived from those audited consolidated financial statements.

Use of Estimates. The preparation of the accompanying unaudited consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the unaudited consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Significant items subject to such estimates include: accrued occupancy costs, insurance liabilities, evaluation for impairment of goodwill, long-lived assets and franchise rights, lease accounting matters, the valuation of assets and liabilities acquired and the valuation of deferred income tax assets. Actual results could differ from those estimates.

Segment Information. Operating segments are components of an entity for which separate financial information is available and is regularly reviewed by the chief operating decision maker in order to allocate resources and assess performance. The Company's chief operating decision maker currently evaluates the Company's operations from a number of different operational perspectives; however resource allocation decisions are made at a total-Company basis. The Company derives all significant revenues from a single operating segment. Accordingly, the Company views the operating results of its Burger King restaurants as one reportable segment.

Business Combinations. In accordance with ASC 805, Business Combinations, the Company allocates the purchase price of an acquired business to its net identifiable assets and liabilities based on the estimated fair values. The excess of the purchase price over the amount allocated to the assets and liabilities, if any, is recorded as goodwill. The Company uses all available information to estimate fair values of identifiable intangible assets and property

6

acquired. In making these determinations, the Company may engage an independent third party valuation specialist to assist with the valuation of certain leasehold improvements, franchise rights and favorable and unfavorable leases. The Company estimates that the seller's carrying value of acquired restaurant equipment, subject to certain adjustments, and restaurant equipment subject to capital leases is equivalent to fair value of this equipment at the date of the acquisitions. The fair values of assumed franchise agreements are valued as if the remaining term of the agreement is at the market rate. The fair values of acquired land, buildings and certain leasehold improvements are determined using both the cost approach and market approach.The fair value of the favorable and unfavorable leases acquired, as well as the fair value of land, buildings and leasehold improvements acquired, is measured using significant inputs observable in the open market. The Company categorizes all such inputs as Level 2 inputs under ASC 820. The fair value of acquired franchise rights is primarily determined using the income approach.

Fair Value of Financial Instruments. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants on the measurement date. In determining fair value, the accounting standards establish a three level hierarchy for inputs used in measuring fair value as follows: Level 1 inputs are quoted prices in active markets for identical assets or liabilities; Level 2 inputs are observable for the asset or liability, either directly or indirectly, including quoted prices in active markets for similar assets or liabilities; and Level 3 inputs are unobservable and reflect our own assumptions. Financial instruments include cash, accounts receivable, accounts payable and long-term debt. The carrying amounts of cash, accounts receivable and accounts payable approximate fair value because of the short-term nature of these financial instruments. The fair value of the Carrols Restaurant Group 8.0% Senior Secured Second Lien Notes due 2022 is based on a recent trading value, which is considered Level 2, and at October 2, 2016 was approximately $216.3 million.

Fair value measurements of non-financial assets and non-financial liabilities are primarily used in the impairment analysis of long-lived assets and intangible assets. Long-lived assets and definite-lived intangible assets are measured at fair value on a nonrecurring basis using Level 3 inputs. Goodwill is reviewed annually for impairment on the last day of the fiscal year, or more frequently if impairment indicators arise.

Recently Issued Accounting Pronouncements. In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842), which requires the recognition of lease assets and lease liabilities on the balance sheet and the disclosure of key information about leasing arrangements. This ASU is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. The ASU requires a modified retrospective approach to implementation for leases existing at or subsequent to the earliest comparative period presented in the financial statements. The Company is currently evaluating the impact the adoption of this standard will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which to simplifies certain elements of accounting for employee share-based payment transactions, including income tax consequences, the classification of awards as either equity or liabilities, and classification on the statement of cash flows. This ASU is effective for reporting periods beginning after December 15, 2016 with early adoption permitted. The Company is currently evaluating the impact the adoption of this standard will have on its consolidated financial statements.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

2. Acquisitions

In 2012, as part of an acquisition of restaurants from Burger King Corporation ("BKC"), the Company was assigned BKC's right of first refusal on franchisee restaurant sales in 20 states (the "ROFR"). Since the beginning of 2015, the Company has acquired an aggregate of 84 restaurants from other franchisees in the following transactions:

Closing Date		Number of Restaurants	Purchase Price	Number of Fee-Owned Restaurants (1)	Market Location
2015 Acquisitions:					
March 31, 2015		4	$794		Northern Vermont
August 4, 2015		5	663		Charlotte, North Carolina
October 1, 2015	(2)	5	5,044	1	Wheeling, West Virginia
October 20, 2015		1	709		Kalamazoo, Michigan
November 17, 2015		2	618		Evansville, Indiana
November 17, 2015	(2)	6	10,945	5	Evansville, Indiana
December 1, 2015	(2)	23	26,175	10	Detroit, Michigan
December 8, 2015		9	7,802		Northern New Jersey
		55	52,750	16	
2016 Acquisitions:					
February 23, 2016	(2)	12	7,127		Scranton/Wilkes-Barre, Pennsylvania
May 25, 2016		6	12,080	5	Detroit, Michigan
July 14, 2016	(2)	4	5,445	3	Detroit, Michigan
August 23, 2016		7	8,755	6	Portland, Maine
		29	33,407	14	
Total 2015 and 2016 Acquisitions		84	$86,157	30	

(1) The 2015 and 2016 acquisitions included the purchase of 30 fee-owned restaurants. Three of these fee-owned restaurants were sold in sale-leaseback transactions during 2015 for net proceeds of $4.3 million and an additional seventeen fee-owned restaurants were sold in sale-leaseback transactions in the first nine months of 2016 for net proceeds of $24.9 million. Eight of the remaining fee-owned restaurants at October 2, 2016 are expected to be sold in sale-leaseback transactions during the remainder of 2016, although there can be no assurance that such transactions will be completed in 2016 or at all.

(2) Acquisitions resulting from the exercise of the ROFR.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

The Company allocated the aggregate purchase price to the net tangible and intangible assets acquired in the acquisitions at their estimated fair values. The following table summarizes the allocation of the aggregate purchase price for the 2016 Acquisitions:

Inventory	$304
Land and buildings	17,872
Restaurant equipment	772
Restaurant equipment - subject to capital lease	435
Leasehold improvements	1,070
Franchise fees	505
Franchise rights (Note 3)	12,537
Favorable leases (Note 3)	73
Goodwill (Note 3)	1,366
Capital lease obligations for restaurant equipment	(491)
Unfavorable leases (Note 3)	(1,036)
Net assets acquired	$33,407

Goodwill recorded in connection with these acquisitions was attributable to the workforce of the acquired restaurants and synergies expected to arise from cost savings opportunities. Acquired goodwill that is expected to be deductible for income tax purposes was $679 in the first nine months of 2016.

The restaurants acquired in 2015 and 2016 contributed restaurant sales of $26.0 million and $68.3 million in the three and nine months ended October 2, 2016, respectively. It is impracticable to disclose net earnings for the post-acquisition period for the acquired restaurants as net earnings of these restaurants were not tracked on a collective basis due to the integration of administrative functions, including field supervision.

The unaudited pro forma impact on the results of operations for the restaurants acquired in 2016 and 2015 for the three and nine months ended October 2, 2016 and September 27, 2015 is included below. The unaudited pro forma results of operations are not necessarily indicative of the results that would have occurred had the acquisitions been consummated at the beginning of the periods presented, nor are they necessarily indicative of any future consolidated operating results. The following table summarizes the Company's unaudited pro forma operating results:

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Restaurant sales	$240,370	$ 244,845	$716,008	$ 709,171
Net income (loss)	$4,950	$ 9,705	$17,691	$ (727)
Basic and diluted net income (loss) per share	$0.11	$ 0.22	$0.39	$ (0.02)

This unaudited pro forma financial information does not give effect to any anticipated synergies, operating efficiencies or cost savings or any integration costs related to the acquired restaurants. The unaudited pro forma financial information reflects $0.5 million and $0.1 million of transaction costs incurred by the Company during the the three months ended October 2, 2016 and September 27, 2015, respectively, and $1.1 million and $0.3 million during the nine months ended October 2, 2016 and September 27, 2015, respectively.

On October 4, 2016, the Company completed the acquisition of three Burger King restaurants in the Raleigh, North Carolina market for a cash purchase price of $1.6 million.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

3. Intangible Assets

Goodwill. The Company is required to review goodwill for impairment annually, or more frequently, when events and circumstances indicate that the carrying amount may be impaired. If the determined fair value of goodwill is less than the related carrying amount, an impairment loss is recognized. The Company performs its annual impairment assessment as of the last day of its fiscal year and does not believe circumstances have changed since the last assessment date which would make it necessary to reassess its value. There have been no recorded goodwill impairment losses during the three and nine months ended October 2, 2016 or September 27, 2015. The change in goodwill for the nine months ended October 2, 2016 is summarized below:

Balance at January 3, 2016	$20,438
Acquisitions of restaurants (Note 2)	1,366
Balance at October 2, 2016	$21,804

Franchise Rights. Amounts allocated to franchise rights for each acquisition of Burger King restaurants are amortized using the straight-line method over the average remaining term of the acquired franchise agreements plus one twenty-year renewal period.

The Company assesses the potential impairment of franchise rights whenever events or changes in circumstances indicate that the carrying value may not be recoverable. If an indicator of impairment exists, an estimate of the aggregate undiscounted cash flows from the acquired restaurants is compared to the respective carrying value of franchise rights for each acquisition. If an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value. No impairment charges were recorded related to the Company's franchise rights for the three and nine months ended October 2, 2016 and September 27, 2015. The change in franchise rights for the nine months ended October 2, 2016 is summarized below:

Balance at January 3, 2016	$118,881
Acquisitions of restaurants (Note 2)	12,537
Amortization expense	(4,401)
Balance at October 2, 2016	$127,017

Amortization expense related to franchise rights was $1.5 million and $1.2 million for the three months ended October 2, 2016 and September 27, 2015, respectively, and $4.4 million and $3.4 million for the nine months ended October 2, 2016 and September 27, 2015, respectively. The Company expects annual amortization expense to be $5.9 million in 2016 and in each of the following five years.

Favorable and Unfavorable Leases. Amounts allocated to favorable and unfavorable leases are being amortized using the straight-line method over the remaining terms of the underlying lease agreements as a net reduction of restaurant rent expense. Additions to favorable lease assets and unfavorable lease liabilities from the 2016 acquisitions included in Note 2 totaled $0.1 million and $1.0 million, respectively, for the nine months ended October 2, 2016.

The net reduction of rent expense related to the amortization of favorable and unfavorable leases was $0.2 million in each of the three months ended October 2, 2016 and September 27, 2015 and $0.6 million in each of the nine months ended October 2, 2016 and September 27, 2015. The Company expects the net annual reduction of rent expense to be $0.8 million in 2016, $0.7 million in 2017 and 2018, $0.6 million in 2019 and 2020, and $0.5 million in 2021.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

4. Impairment of Long-Lived Assets and Other Lease Charges

The Company reviews its long-lived assets, principally property and equipment, for impairment at the restaurant level. If an indicator of impairment exists for any of its assets, an estimate of the undiscounted future cash flows over the life of the primary asset for each restaurant is compared to that long-lived asset's carrying value. If the carrying value is greater than the undiscounted cash flow, the Company then determines the fair value of the asset and if an asset is determined to be impaired, the loss is measured by the excess of the carrying amount of the asset over its fair value. For closed restaurant locations, the Company reviews the future minimum lease payments and related ancillary costs from the date of the restaurant closure to the end of the remaining lease term and records a lease charge for the lease liabilities to be incurred, net of any estimated sublease recoveries.

The Company determined the fair value of restaurant equipment, for those restaurants reviewed for impairment, based on current economic conditions and the Company's history of using these assets in the operation of its business. These fair value asset measurements rely on significant unobservable inputs and are considered Level 3 in the fair value hierarchy.

During the three months ended October 2, 2016, the Company recorded asset impairment charges of $0.3 million consisting primarily of capital expenditures at previously impaired restaurants, a loss of $0.3 million associated with a sale-leaseback of a restaurant property, and $0.1 million of other lease charges associated with changes in sublease income assumptions on previously closed restaurants. During the nine months ended October 2, 2016, the Company recorded impairment charges of $1.2 million consisting additionally of capital expenditures at previously impaired restaurants.

During the three months ended September 27, 2015, the Company recorded asset impairment charges of $0.4 million resulting primarily from capital expenditures at previously impaired restaurants. During the nine months ended September 27, 2015, the Company recorded other lease charges of $1.5 million associated with the closure of ten of the Company's restaurants and asset impairment charges of $1.2 million, including $1.0 million of capital expenditures at previously impaired restaurants.

The following table presents the activity in the accrual for closed restaurant locations:

	Nine Months Ended October 2, 2016	Year Ended January 3, 2016
Balance, beginning of the period	$ 2,088	$ 1,721
Provisions for restaurant closures	—	1,472
Changes in estimates of accrued costs	(80)	(95)
Payments, net	(581)	(1,228)
Other adjustments, including the effect of discounting future obligations	114	218
Balance, end of the period	$ 1,541	$ 2,088

Changes in estimates of accrued costs primarily relate to revisions or terminations of certain closed restaurant leases, changes in sublease income assumptions and other costs.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

5. Other Liabilities, Long-Term

Other liabilities, long-term, at October 2, 2016 and January 3, 2016 consisted of the following:

	October 2, 2016	January 3, 2016
Accrued occupancy costs	$ 11,747	$ 10,473
Accrued workers' compensation and general liability claims	3,254	3,606
Deferred compensation	1,542	997
Long-term obligation to BKC for ROFR	—	190
Other	1,928	1,849
	$ 18,471	$ 17,115

Long-term accrued occupancy costs above include obligations pertaining to closed restaurant locations, contingent rent and accruals to expense operating lease rental payments on a straight-line basis over the lease term.

6. Sale-leaseback Transactions

In the three and nine months ended October 2, 2016, the Company sold eight and 20 restaurant properties, respectively, in sale-leaseback transactions for net proceeds of $11,707 and $29,394, respectively. In the nine months ended September 27, 2015, the Company sold three restaurant properties in sale-leaseback transactions for net proceeds of $3,136, none of which occurred in the three months ended September 27, 2015. These leases have been classified as operating leases and contain a twenty-year initial term plus renewal options.

Deferred gains from sale-leaseback transactions of restaurant properties were $392 and $954 during the three and nine months ended October 2, 2016, respectively, and are being amortized over the term of the related leases. There were no deferred gains from sale-leaseback transactions during the nine months ended September 27, 2015.

7. Long-term Debt

Long-term debt at October 2, 2016 and January 3, 2016 consisted of the following:

	October 2, 2016	January 3, 2016
Collateralized:		
Carrols Restaurant Group 8% Senior Secured Second Lien Notes	$200,000	$200,000
Senior Credit Facility - Revolving credit borrowings	10,500	—
Capital leases	7,396	8,006
	217,896	208,006
Less: current portion	(1,585)	(1,435)
Less: deferred financing costs	(3,994)	(4,529)
	$212,317	$202,042

8% Notes. On April 29, 2015, the Company issued $200 million of 8.0% Senior Secured Second Lien Notes due 2022 (the "8% Notes") pursuant to an indenture dated as of April 29, 2015 governing such notes. The 8% Notes mature and are payable on May 1, 2022. Interest is payable semi-annually on May 1 and November 1. The 8% Notes are guaranteed by the Company's subsidiaries and are secured by second-priority liens on substantially all of the Company's and its subsidiaries' assets (including a pledge of all of the capital stock and equity interests of its subsidiaries). The Company recorded a loss on debt extinguishment of $12.6 million in the second quarter of 2015 due to the repurchase and redemption of its prior 11.25% Senior Secured Second Lien Notes.

The 8% Notes are redeemable at the option of the Company in whole or in part at any time after May 1, 2018 at a price of 104% of the principal amount plus accrued and unpaid interest, if any, if redeemed before May 1, 2019, 102% of the principal amount plus accrued and unpaid interest, if any, if redeemed after May 1, 2019 but before May 1,

2020 and 100% of the principal amount plus accrued and unpaid interest, if any, if redeemed after May 1, 2020. Prior to May 1, 2018, the Company may redeem some or all of the 8% Notes at a redemption price of 100% of the principal amount of each note plus accrued and unpaid interest, if any, and a make-whole premium. In addition, the indenture governing the 8% Notes also provides that the Company may redeem up to 35% of the 8% Notes using the proceeds of certain equity offerings completed before May 15, 2018.

The 8% Notes are jointly and severally guaranteed, unconditionally and in full by the Company's subsidiaries which are directly or indirectly 100% owned by the Company. Separate condensed consolidating information is not included because Carrols Restaurant Group is a holding company that has no independent assets or operations. There are no significant restrictions on its ability or any of the guarantor subsidiaries' ability to obtain funds from its respective subsidiaries. All consolidated amounts in our unaudited consolidated financial statements are representative of the combined guarantors.

The indenture governing the 8% Notes includes certain covenants, including limitations and restrictions on the Company and its subsidiaries who are guarantors under such indenture to, among other things: incur indebtedness or issue preferred stock; incur liens; pay dividends or make distributions in respect of capital stock or make certain other restricted payments or investments; sell assets; agree to payment restrictions affecting certain subsidiaries; enter into transaction with affiliates; or merge, consolidate or sell substantially all of the Company's assets.

The indenture governing the 8% Notes and the security agreement provide that any capital stock and equity interests of any of the Company's subsidiaries will be excluded from the collateral to the extent that the par value, book value or market value of such capital stock or equity interests exceeds 20% of the aggregate principal amount of the 8% Notes then outstanding.

The indenture governing the 8% Notes contains customary default provisions, including without limitation, a cross default provision pursuant to which it is an event of default under the 8% Notes and the indenture governing the 8% Notes if there is a default under any of the Company's indebtedness having an outstanding principal amount of $20.0 million or more which results in the acceleration of such indebtedness prior to its stated maturity or is caused by a failure to pay principal when due.

Senior Credit Facility. On May 30, 2012, the Company entered into a senior credit facility, which was most recently amended on February 12, 2016 to provide for aggregate revolving credit borrowings of up to $55.0 million (including $20.0 million available for letters of credit) and to extend the maturity date to February 12, 2021. The senior credit facility also provides for potential incremental borrowing increases of up to $25.0 million, in the aggregate. As of October 2, 2016, $10.5 million in revolving credit borrowings were outstanding under the senior credit facility. After reserving $13.4 million for letters of credit issued under the senior credit facility, $31.1 million was available for revolving credit borrowings under the senior credit facility at October 2, 2016.

Borrowings under the senior credit facility bear interest at a rate per annum, at the Company’s option, of:

(i) the Alternate Base Rate plus the applicable margin of 1.75% to 2.75% based on the Company’s Adjusted Leverage Ratio, or

(ii) the LIBOR Rate plus the applicable margin of 2.75% to 3.75% based on the Company’s Adjusted Leverage Ratio (all terms as defined under the senior credit facility).

At October 2, 2016 the Company's LIBOR Rate margin was 2.75% and the Alternate Base Rate margin was 1.75% based on the Company's Adjusted Leverage Ratio at the end of the second quarter of 2016.

The Company’s obligations under the senior credit facility are guaranteed by its subsidiaries and are secured by first priority liens on substantially all of the assets of the Company and its subsidiaries, including a pledge of all of the capital stock and equity interests of its subsidiaries.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

Under the senior credit facility, the Company is required to make mandatory prepayments of borrowings in the event of dispositions of assets, debt issuances and insurance and condemnation proceeds (all subject to certain exceptions). The senior credit facility contains certain covenants, including without limitation, those limiting the Company's and its subsidiaries' ability to, among other things, incur indebtedness, incur liens, sell or acquire assets or businesses, change the character of its business in all material respects, engage in transactions with related parties, make certain investments, make certain restricted payments or pay dividends. In addition, the senior credit facility requires the Company to meet certain financial ratios, including a Fixed Charge Coverage Ratio, Adjusted Leverage Ratio and First Lien Leverage Ratio (all as defined under the senior credit facility). The Company was in compliance with the covenants under its senior credit facility at October 2, 2016.

The senior credit facility contains customary default provisions, including that the lenders may terminate their obligation to advance and may declare the unpaid balance of borrowings, or any part thereof, immediately due and payable upon the occurrence and during the continuance of customary defaults which include, without limitation, payment default, covenant defaults, bankruptcy type defaults, cross-defaults on other indebtedness, judgments or upon the occurrence of a change of control.

8. Income Taxes

The provision (benefit) for income taxes for the three and nine months ended October 2, 2016 and September 27, 2015 was comprised of the following:

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Current	$ —	$ —	$ —	$ —
Deferred	(466)	1,989	2,175	(4,210)
Valuation allowance	466	(1,989)	(2,175)	4,210
	$ —	$ —	$ —	$ —

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amount used for income tax purposes.

Since 2014, the Company has recorded a valuation allowance on all of its net deferred income tax assets. The Company performs an ongoing assessment of positive and negative evidence regarding the realization of its deferred income tax assets as required by ASC 740. Under ASC 740, the weight given to negative and positive evidence is commensurate only to the extent that such evidence can be objectively verified. ASC 740 also prescribes that objective historical evidence, in particular the Company's three-year cumulative loss position at October 2, 2016, be given greater weight than subjective evidence, including the Company's forecasts of future taxable income, which include assumptions that cannot be objectively verified. The Company determined, based on the required weight of that evidence under ASC 740, that a valuation allowance was still needed on all of its net deferred income tax assets at October 2, 2016. Consequently, the Company recorded no provision or benefit for income taxes in the three and nine months ended October 2, 2016 and September 27, 2015.

The Company increased its valuation allowance by $0.5 million in the three months ended October 2, 2016 due primarily to an increase in net deferred tax assets during the period. The valuation allowance decreased $1.9 million in the nine months ended October 2, 2016 due primarily to the reduction of federal and state net operating loss carryforwards. At October 2, 2016, the Company's valuation allowance on all its net deferred tax assets was $28.5 million.

In the three months ended September 27, 2015, the Company decreased its valuation allowance by $1.9 million and in the nine months ended September 27, 2015 increased its valuation allowance by $4.3 million for changes in the net deferred income tax assets recognized in the respective periods.

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

The Company's federal net operating loss carryforwards expire beginning in 2033. As of October 2, 2016, the Company had federal net operating loss carryforwards of approximately $53.5 million. The Company's state net operating loss carryforwards expire beginning in 2017 through 2034.

The estimation of future taxable income for federal and state purposes and the Company's ability to realize deferred tax assets can significantly change based on future events and operating results. Thus, recorded valuation allowances may be subject to future changes that could have a material impact on the consolidated financial statements. If the Company determines that it is more likely than not that it will realize these deferred tax assets in the future, the Company will make an adjustment to the valuation allowance at that time.

The Company's policy is to recognize interest and/or penalties related to uncertain tax positions in income tax expense. At October 2, 2016 and January 3, 2016, the Company had no unrecognized tax benefits and no accrued interest related to uncertain tax positions. The tax years 2013 - 2015 remain open to examination by the major taxing jurisdictions to which the Company is subject. Although it is not reasonably possible to estimate the amount by which unrecognized tax benefits may increase within the next twelve months due to the uncertainties regarding the timing of any examinations, the Company does not expect unrecognized tax benefits to significantly change in the next twelve months.

9. Stock-Based Compensation

Stock-based compensation expense was $0.5 million and $0.4 million in the three months ended October 2, 2016 and September 27, 2015, respectively, and $1.6 million and $1.1 million in the nine months ended October 2, 2016 and September 27, 2015, respectively.

A summary of all non-vested shares activity for the nine months ended October 2, 2016 was as follows:

	Shares	Weighted Average Grant Date Price
Non-vested at January 3, 2016	468,770	$ 7.40
Granted	327,140	12.28
Vested	(215,509)	6.72
Non-vested at October 2, 2016	580,401	$ 10.40

The fair value of non-vested shares is based on the closing price on the date of grant. As of October 2, 2016, the total unrecognized stock-based compensation expense was approximately $4.9 million, which the Company expects to recognize over a remaining weighted average vesting period for non-vested shares of 2.9 years. The Company expects to record an additional $0.4 million in stock-based compensation expense for the remainder of 2016.

10. Commitments and Contingencies

Lease Guarantees. Fiesta Restaurant Group, Inc. ("Fiesta"), a former wholly-owned subsidiary of the Company, was spun-off in 2012 to the Company's stockholders. As of October 2, 2016, the Company is a guarantor under 27 Fiesta restaurant property leases, with lease terms expiring on various dates through 2030, and is the primary lessee on five Fiesta restaurant property leases, which it subleases to Fiesta. The Company is fully liable for all obligations under the terms of the leases in the event that Fiesta fails to pay any sums due under the lease, subject to indemnification provisions of the Separation and Distribution Agreement entered into in connection with the spin-off of Fiesta.

The maximum potential amount of future undiscounted rental payments the Company could be required to make under these leases at October 2, 2016 was $26.4 million. The obligations under these leases will generally continue to decrease over time as these operating leases expire. No payments related to these guarantees have been made by the Company to date and none are expected to be required to be made in the future. The Company has not recorded a liability for these guarantees in accordance with ASC 460 - Guarantees as Fiesta has indemnified the Company for all

15

such obligations and the Company did not believe it was probable it would be required to perform under any of the guarantees or direct obligations.

Litigation. On August 21, 2012 Alan Vituli, the Company's former chairman and chief executive officer, filed an action in the Superior Court of the State of Delaware (the "Court") against the Company and Carrols. On July 29, 2016 the Company, Carrols, and Mr. Vituli agreed to fully resolve all of Mr. Vituli's claims in the lawsuit for a total payment by the Company of $2.0 million, which was paid on September 15, 2016. The Company accrued $1.85 million in the second quarter of 2016 for this settlement which was net of a contribution from its insurance carrier and is reflected in other income (expense) in the accompanying unaudited consolidated statements of comprehensive income (loss). Upon the execution of releases and payment of the settlement amount, the litigation was dismissed.

The Company is a party to various other litigation matters that arise in the ordinary course of business. The Company does not believe that the outcome of any of these other matters meet the disclosure or recognition standards, nor will they have a material adverse effect on its consolidated financial statements.

11. Transactions with Related Parties

In connection with an acquisition of restaurants from BKC in 2012, the Company issued to BKC 100 shares of Series A Convertible Preferred Stock which is convertible into 9,414,580 shares of Carrols Restaurant Group Common Stock, which currently constitutes approximately 20.8% of the outstanding shares of the Company's common stock on a fully diluted basis. Pursuant to the terms of the Series A Convertible Preferred Stock, BKC also has two representatives on the Company's board of directors.

Each of the Company's restaurants operates under a separate franchise agreement with BKC. These franchise agreements generally provide for an initial term of twenty years and currently have an initial franchise fee of fifty thousand dollars. Any franchise agreement, including renewals, can be extended at the Company's discretion for an additional twenty-year term, with BKC's approval, provided that among other things, the restaurant meets the current Burger King image standard and the Company is not in default under terms of the franchise agreement. In addition to the initial franchise fee, the Company generally pays BKC a monthly royalty at a rate of 4.5% of sales. Royalty expense was $10.1 million and $9.2 million in the three months ended October 2, 2016 and September 27, 2015, respectively, and was $29.7 million and $26.5 million in the nine months ended October 2, 2016 and September 27, 2015, respectively.

The Company is also generally required to contribute 4% of restaurant sales from its restaurants to an advertising fund utilized by BKC for its advertising, promotional programs and public relations activities, and additional amounts for participation in local advertising campaigns in markets that approve such additional spending. Advertising expense related to BKC was $10.5 million and $8.1 million in the three months ended October 2, 2016 and September 27, 2015, respectively, and was $30.0 million and $23.5 million in the nine months ended October 2, 2016 and September 27, 2015, respectively.

As of October 2, 2016, the Company leased 285 of its restaurant locations from BKC and for 157 of these locations the terms and conditions of the lease with BKC are identical to those between BKC and the third-party lessor. Aggregate rent related to BKC leases for the three months ended October 2, 2016 and September 27, 2015 was $7.2 million and $7.0 million, respectively, and was $21.7 million and $21.4 million in the nine months ended October 2, 2016 and September 27, 2015, respectively. The Company believes the related party lease terms have not been significantly affected by the fact that the Company and BKC are deemed related parties.

As of October 2, 2016, the Company owed BKC $0.4 million associated with its purchase of the ROFR and $6.5 million related to the payment of advertising, royalties and rent, which is remitted on a monthly basis.

12. Net Income (Loss) per Share

The Company applies the two-class method to calculate and present net income (loss) per share. The Company's non-vested share awards and Series A Convertible Preferred Stock issued to BKC contain non-forfeitable rights to dividends and are considered participating securities for purposes of computing net income (loss) per share pursuant

CARROLS RESTAURANT GROUP, INC.
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS—(Continued)
(in thousands of dollars except share and per share amounts)

to the two-class method. Under the two-class method, net earnings are reduced by the amount of dividends declared (whether paid or unpaid) and the remaining undistributed earnings are then allocated to common stock and participating securities, based on their respective rights to receive dividends. As the Company incurred a net loss for the nine months ended September 27, 2015 and losses are not allocated to participating securities under the two-class method, such method is not applicable for the aforementioned interim reporting period.

Basic net income (loss) per share is computed by dividing net income (loss) available to common shareholders by the weighted average number of shares of common stock outstanding for the reporting period. Diluted net income (loss) per share reflects additional shares of common stock outstanding, where applicable, calculated using the treasury stock method or the two-class method.

The following table sets forth the calculation of basic and diluted net income (loss) per share:

	Three Months Ended		Nine Months Ended	
	October 2, 2016	September 27, 2015	October 2, 2016	September 27, 2015
Basic net income (loss) per share:				
Net income (loss)	$4,489	$ 7,239	$16,010	$ (7,014)
Less: Income attributable to non-vested shares	(60)	(80)	(240)	—
Less: Income attributable to preferred stock	(934)	(1,517)	(3,332)	—
Net income (loss) available to common stockholders	$3,495	$ 5,642	$12,438	$ (7,014)
Weighted average common shares outstanding	35,237,053	35,009,656	35,152,091	34,930,326
Basic net income (loss) per share	$0.10	$ 0.16	$0.35	$ (0.20)
Diluted net income (loss) per share:				
Net income (loss)	$4,489	$ 7,239	$16,010	$ (7,014)
Shares used in computing basic net income (loss) per share	35,237,053	35,009,656	35,152,091	34,930,326
Dilutive effect of preferred stock and non-vested shares	9,618,725	9,668,858	9,740,097	—
Shares used in computing diluted net income (loss) per share	44,855,778	44,678,514	44,892,188	34,930,326
Diluted net income (loss) per share (1)	$0.10	$ 0.16	$0.35	$ (0.20)
Shares excluded from diluted net income (loss) per share computations (2)	—	—	—	9,886,530