

Meritage Hospitality Group Inc. and Subsidiaries

**Consolidated Financial Report
July 3, 2016 and June 28, 2015**

Meritage Hospitality Group Inc. and Subsidiaries

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Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Balance Sheet (unaudited)

	July 3, 2016	January 3, 2016
Assets		
Current Assets		
Cash	\$ 6,167,852	\$ 6,587,845
Receivables	275,628	428,196
Inventories	1,445,451	1,401,707
Prepaid expenses and other current assets	2,558,721	2,515,490
Total Current Assets	10,447,652	10,933,238
Property and Equipment - Net	48,636,269	49,072,061
Goodwill	43,551,550	38,016,614
Intangible Assets	853,888	880,578
Deferred Income Taxes	1,737,407	2,332,186
Other Assets		
Notes receivable	548,215	548,215
Long-term investments	5,317,504	5,261,724
Deposits and other assets	2,978,026	1,975,441
Total Assets	\$ 114,070,511	\$ 109,020,057
Liabilities and Equity		
Current Liabilities		
Trade accounts payable	\$ 6,626,247	\$ 10,027,501
Revolving line of credit	3,551,811	6,792,864
Current portion of long-term debt	11,465,137	6,586,265
Accrued liabilities	8,961,563	9,512,562
Total Current Liabilities	30,604,758	32,919,192
Unearned Vendor Allowances	1,887,225	565,906
Accrued Rent	2,820,701	2,664,792
Deferred Compensation	2,598,323	1,780,525
Long-term Debt - Net of current portion	42,830,555	40,722,124
Deferred Gain - Sale and leaseback transactions	10,357,942	9,834,161
Equity	22,971,007	20,533,357
Total Liabilities and Equity	\$ 114,070,511	\$ 109,020,057

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Statement of Operations (unaudited)

	Three Months Ended	
	July 3, 2016	June 28, 2015
Food and Beverage Revenue	\$ 58,596,928	\$ 51,029,015
Costs and Expenses		
Cost of food and beverages	15,357,259	13,576,548
Labor and related expenses	17,089,969	14,482,571
Advertising expenses	2,504,617	2,087,638
Other operating expenses	14,729,189	13,132,071
Total Operating Expenses	49,681,034	43,278,828
General and administrative expenses	3,318,312	3,028,736
Preopening and acquisition expenses	537,796	125,899
Closing and disposition expenses	(263,814)	701,799
Depreciation and amortization	1,334,143	971,237
Total Costs and Expenses	54,607,471	48,106,499
Income from Operations	3,989,457	2,922,516
Other Expense (Income)		
Interest expense	752,750	575,303
Other expense (income)	4,306	(1,264,329)
Total Other Expense (Income)	757,056	(689,026)
Income Before Income Taxes	3,232,401	3,611,542
Income Tax Expense	1,172,406	1,445,224
Net Income	\$ 2,059,995	\$ 2,166,318

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Statement of Operations (unaudited)

	Six Months Ended	
	July 3, 2016	June 28, 2015
Food and Beverage Revenue	\$ 112,649,615	\$ 97,482,143
Costs and Expenses		
Cost of food and beverages	29,595,962	26,327,596
Labor and related expenses	33,379,605	28,255,197
Advertising expenses	4,744,684	3,996,039
Other operating expenses	28,792,085	25,642,272
Total Operating Expenses	96,512,336	84,221,104
General and administrative expenses	6,180,881	5,475,241
Preopening and acquisition expenses	954,120	339,806
Closing and disposition expenses	733,998	706,657
Depreciation and amortization	2,625,097	2,001,365
Total Costs and Expenses	107,006,432	92,744,173
Income from Operations	5,643,183	4,737,970
Other Expense (Income)		
Interest expense	1,475,455	1,163,559
Other expense (income)	152,070	(1,614,937)
Total Other Expense (Income)	1,627,525	(451,378)
Income Before Income Taxes	4,015,658	5,189,348
Income Tax Expense	1,414,354	1,946,053
Net Income	\$ 2,601,304	\$ 3,243,295

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Statement of Equity (unaudited)

	Series A Convertible Preferred Stock	Series B Convertible Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Total
Balance - December 28, 2014	<u>\$ 295</u>	<u>\$ 7,460</u>	<u>\$ 56,075</u>	<u>\$ 17,371,126</u>	<u>\$ (4,403,304)</u>	<u>\$ 13,031,652</u>
Net income					7,026,294	7,026,294
Issuance of 110,000 shares of preferred stock		1,100		1,098,900		1,100,000
Issuance of 43,720 shares of common stock			437	51,522		51,959
Common stock dividends				(337,781)		(337,781)
Preferred stock dividends				(657,564)		(657,564)
Stock option expense				318,797		318,797
Balance - January 3, 2016	<u>\$ 295</u>	<u>\$ 8,560</u>	<u>\$ 56,512</u>	<u>\$ 17,845,000</u>	<u>\$ 2,622,990</u>	<u>\$ 20,533,357</u>
Net income					2,601,304	2,601,304
Issuance of 140,728 shares of common stock			1,407	111,892		113,299
Preferred stock conversion		(32)	57	(25)		-
Common stock dividends				(172,348)		(172,348)
Preferred stock dividends				(355,684)		(355,684)
Stock option expense				251,079		251,079
Balance - July 3, 2016	<u>\$ 295</u>	<u>\$ 8,528</u>	<u>\$ 57,976</u>	<u>\$ 17,679,914</u>	<u>\$ 5,224,294</u>	<u>\$ 22,971,007</u>

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Statement of Cash Flows (unaudited)

	Six Months Ended	
	July 3, 2016	June 28, 2015
Cash Flows from Operating Activities		
Net Income	\$ 2,601,304	\$ 3,243,295
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	2,625,097	2,001,365
Amortization of financing costs	77,502	73,393
Deferred income taxes	594,779	797,488
Amortization of deferred gain from sale and leaseback transactions	(445,014)	(1,469,575)
Compensation paid by issuance of common stock	17,975	18,022
Loss on disposal of fixed assets	418,202	21,981
Stock option expense	251,079	144,421
Changes in operating assets and liabilities which provided (used) cash:		
Receivables	152,568	(102,643)
Inventories	6,549	75,437
Prepaid expenses and other current assets	(43,231)	308,222
Deposits and other assets	(1,007,704)	(384,215)
Accounts payable	(3,401,254)	36,857
Accrued liabilities	(622,999)	1,503,126
Deferred Compensation	817,798	414,780
Accrued rent	155,909	117,756
Unearned vendor allowances	1,166,385	872,934
Net cash provided by operating activities	3,364,945	7,672,644
Cash Flows from Investing Activities		
Purchase of property and equipment	(7,424,707)	(7,618,426)
Purchase of intangible assets	(40,000)	-
Change in long term investments	(55,780)	(169,257)
Acquisitions, net	(5,670,650)	(6,134,351)
Net cash used in investing activities	(13,191,137)	(13,922,034)

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Consolidated Statement of Cash Flows (unaudited) Continued

	Six Months Ended	
	July 3, 2016	June 28, 2015
Cash Flows from Financing Activities		
Proceeds from long-term debt	10,716,872	5,000,000
Proceeds from revolving line of credit - net	1,866,010	4,115,836
Proceeds from sale leaseback transactions	6,170,157	6,303,342
Principal payments on long-term debt	(3,663,634)	(2,197,930)
Payments on capital lease	(127,482)	(100,302)
Payments on debt related to sale leaseback transactions	(5,107,063)	(5,398,365)
Payments of financing costs	(15,954)	(56,440)
Proceeds from sale of common stock	95,325	15,918
Common stock dividends paid	(172,348)	(168,816)
Preferred stock dividends paid	(355,684)	(311,684)
	<u>9,406,199</u>	<u>7,201,559</u>
Net (Decrease) Increase in Cash	(419,993)	952,169
Cash - Beginning of year	<u>6,587,845</u>	<u>5,200,901</u>
Cash - End of period	<u>\$ 6,167,852</u>	<u>\$ 6,153,070</u>
Supplemental Disclosure of Cash Flow Information		
Cash paid for:		
Interest	\$ 1,418,128	\$ 1,093,273
Income taxes	\$ 371,949	\$ 407,225
Significant non-cash investing and financing transactions:		
Deferred gain on sale leaseback transactions	\$ 975,845	\$ 689,719

See notes to consolidated financial statements

Meritage Hospitality Group Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

Note 1 - Consolidation

The consolidated financial statements include the accounts of Meritage Hospitality Group Inc., all of its wholly owned subsidiaries, and its 98.5% owned subsidiary, RDG-MHG, LLC., ("RDG"). RDG is a 15% partner in TRG-Meritage Bahamas, LLC., ("TRG"). All intercompany transactions and balances have been eliminated in consolidation.

Note 2 - Stockholders' Equity

The Company has 5,000,000 authorized shares of \$0.01 par value per share preferred stock. 200,000 shares are designated as Series A convertible cumulative preferred stock, with 29,520 shares issued and outstanding as of July 3, 2016 and January 3, 2016. 1,350,000 shares are designated as Series B convertible cumulative preferred stock, with 852,850 shares issued and outstanding as of July 3, 2016 and 856,000 as of January 3, 2016.

The Company has 30,000,000 authorized shares of \$0.01 par value per share common stock, with 5,797,627 and 5,651,242 shares issued and outstanding as of July 3, 2016 and January 3, 2016, respectively.

Note 3 - Acquisition of Wendy's Restaurants

The Company acquired eight Wendy's restaurants in June 2016. All restaurants acquired included the business and equipment. The Company entered into new lease agreements for all newly acquired locations with the restaurants' building owners, and franchise agreements for all locations with the Company's franchisor, The Wendy's Company. The acquisition was financed with approximately \$4,800,000 of new debt, and \$871,000 of cash. The transaction resulted in the recording of approximately \$5,535,000 of goodwill, \$312,000 of equipment, \$50,000 of inventory and \$227,000 of liabilities.

The Company expensed \$189,000 of acquisition and preopening costs in 2016 related to the transaction.

Note 4 - Sale Leasebacks

The Company completed three sale and leaseback transactions during the six months ended July 3, 2016. The Company netted proceeds of approximately \$6,170,000, and with such proceeds paid down indebtedness of \$5,107,000, and deposited \$1,048,000 into the Company's treasury. The Company recorded deferred gains of approximately \$969,000. The gains are being amortized over the 20-year lease terms and recorded as a reduction of base rent expense.

Note 5 - Commitments and Contingencies

As part of the Company's ongoing franchise relationship with The Wendy's Company, the Company is required to complete certain agreed upon improvements to facilities as well as reimage a portion of the Wendy's restaurants acquired since 2014 by December 31, 2021. As of July 3, 2016, the Company has remaining estimated capital improvements of \$7,943,000 toward these efforts.

Meritage Hospitality Group Inc. and Subsidiaries

Notes to Unaudited Consolidated Financial Statements

Note 6 - New Accounting Principles

As of January 3, 2016, the Company adopted ASU 2015-3, "Interest-Imputation of Interest: Simplifying the presentation of Debt Issuance Costs", that requires debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct reduction from the carrying amount of that debt liability, consistent with debt discounts and ASU 2015-15 that supplements these requirements by allowing an entity to defer and present debt issue costs related to a line of credit arrangement as an asset and subsequently amortize the costs over the term of the agreement. The new presentation requirements have been applied retrospectively and amounts reported in the balance sheet have been restated by reducing intangible assets and long-term debt by \$441,000 and \$502,000 as of July 3, 2016 and June 28, 2015, respectively.

The new guidance does not affect how the debt issuance costs are accounted for after initial recognition, and these amounts continue to be amortized over the term of the related debt. As a part of adopting the new standard, amortization of debt issuance costs is now reported as a component of interest expense; previously these amounts were reported as a part of amortization expense. The statement of operations has also been restated to report \$90,000 and \$73,000 of amortization of debt issuance costs as a component of interest expense for the six months ended July 3, 2016 and June 28, 2015, respectively, and \$51,000 and \$39,000 for the three months ended July 3, 2016 and June 28, 2015, respectively.

Note 7 - Subsequent Event

On August 9, 2016 the Company acquired ten Wendy's restaurants. The acquisition was financed with approximately \$5,292,000 of new debt, and \$153,000 of cash.