

# Meritage Hospitality Group Inc.

## Quarterly Report

**For Quarterly Period Ended July 2, 2017**

The following information provides updates to the Annual Report for Fiscal Year Ended January 1, 2017. Accordingly, this report does not contain all the information required of an issuer for its initial disclosure obligations, and should therefore be reviewed in conjunction with the Annual Report for Fiscal Year Ended January 1, 2017 and any interim reports or updates provided since the fiscal year-end report.

**Item 1     Exact name of the issuer and the address of its principal executive offices.**

Name of the Company or Issuer:

Meritage Hospitality Group Inc. (the “Company” or “Meritage”).

Address of Principal Office:

45 Ottawa Ave SW, Suite 600

Grand Rapids, MI 49503

Telephone: 616.776.2600

Facsimile: 616.776.2776

Web: [www.meritagehospitality.com](http://www.meritagehospitality.com)

**Item 2     Shares outstanding.**

<u>Common Shares</u>	<u>07/02/17</u>	<u>01/01/17</u>	<u>01/03/16</u>
Authorized:	30,000,000 shares	30,000,000 shares	30,000,000 shares
Outstanding:	6,094,127 shares	5,979,371 shares	5,651,242 shares
Freely Tradable (public float): approx. 3,000,000 shs.		approx. 3,000,000 shs.	approx. 3,000,000 shs.
Number of beneficial holders owning at least 100 shares:	approx. 482 holders	approx. 491 holders	approx. 360 holders
Number of record holders:	approx. 85 holders	approx. 91 holders	approx. 95 holders
<u>Preferred A</u>			
Authorized:	0 shares	200,000 shares	200,000 shares
Outstanding:	0 shares	29,520 shares	29,520 shares
Freely Tradable (public float): 0 shares		29,520 shares	29,520 shares
Number of record holders:	0 holders	2 holders	2 holders
<u>Preferred B</u>			
Authorized:	1,350,000 shares	1,350,000 shares	1,350,000 shares
Outstanding:	828,877 shares	852,850 shares	856,000 shares
Freely Tradable (public float): 300,000 shares		300,000 shares	300,000 shares
Number of record holders:	41 holders	37 holders	39 holders
<u>Preferred C</u>			
Authorized:	1,500,000 shares	0 shares	0 shares
Outstanding:	170,360 shares	0 shares	0 shares
Number of record holders:	7 holders	0 holders	0 holders

### **Item 3 Interim financial statements.**

See the unaudited consolidated financial report for the quarter ended July 2, 2017 attached at the end of this report. The unaudited consolidated financial statements include the following reports:

- (1) balance sheet;
- (2) statement of operations;
- (3) statement of equity;
- (4) statement of cash flows; and
- (5) notes to consolidated financial statements.

### **Item 4 Management's discussion and analysis or plan of operation.**

#### **Overview**

The Company reported revenues of \$78.7 million and \$140.7 million in the three and six months ended July 2, 2017 compared to revenues of \$58.6 million and \$112.7 million for the three and six months ended July 3, 2016, an increase of 34.3% and 24.9%, respectively. The increase in revenues was primarily the result of the acquisition of 69 Wendy's restaurants in the first six months of 2017, a full quarter of sales from the 18 Wendy's restaurants acquired in 2016, and the opening of the Company's new casual dining restaurant, Wheelhouse Kitchen & Cocktails, in May 2016. Additionally, total Company "same store sales" (i.e., food and beverage revenue for stores in full operation on a per period basis for both fiscal years) increased by 3.2% for all restaurants in both the three and six months ended July 2, 2017.

The Company expects to continue to evaluate acquisition opportunities in the Wendy's and casual dining restaurant segments. Since 2009, the Company has acquired 196 Wendy's restaurants through 19 separate transactions.

#### **Results of Operations**

Meritage operates in the quick-service and casual dining restaurant industries. The Company has experienced significant growth through its acquisition efforts in quick-service and the launch of its own independent concepts, Twisted Rooster, Crooked Goose, Freighters Eatery & Taproom, and Wheelhouse Kitchen & Cocktails. At July 2, 2017, the Company operated 243 Wendy's quick-service restaurants under franchise agreements with The Wendy's Company and six casual dining restaurants. Of the Wendy's restaurants, 54 are located in Michigan, 49 in Florida, 37 in Georgia, two in North Carolina, one in South Carolina, 10 in Virginia, 15 in Ohio, 18 in Oklahoma, 10 in Arkansas, seven in Mississippi, three in Missouri, and 37 in Tennessee. All six casual dining restaurants are located in Michigan.

A schedule of Company restaurants follows:

	<u>Wendy's</u>	<u>Casual Dining</u>	<u>Total Restaurants</u>
Restaurants as of January 3, 2016	161	5	166
Acquired restaurants	18	-	18
Newly opened restaurants	3	1	4
Closed restaurants	-7	-	-7
Restaurants as of January 1, 2017	175	6	181
Acquired restaurants	69	-	69
Newly opened restaurants	1	-	1
Closed restaurants	-2	-	-2
Restaurants as of July 2, 2017	243	6	249

Results of operations are summarized below.

	Three Months Ended (000's)				Six Months Ended (000's)			
	<u>7/2/2017</u>		<u>7/3/2016</u>		<u>7/2/2017</u>		<u>7/3/2016</u>	
Food and Beverage Revenue	\$ 78,715	100%	\$ 58,597	100%	\$ 140,731	100%	\$ 112,650	100%
Costs and Expenses								
Cost of food and beverages	21,150	26.9	15,357	26.2	37,214	26.4	29,596	26.3
Labor and related expenses	22,286	28.3	17,090	29.2	40,380	28.7	33,380	29.6
Advertising expenses	3,335	4.2	2,505	4.3	5,954	4.2	4,745	4.2
Other operating expenses	19,233	24.4	14,729	25.1	35,086	24.9	28,792	25.6
Total Operating Expenses	66,003	83.9	49,681	84.8	118,634	84.3	96,512	85.7
General and administrative expenses	4,408	5.6	3,318	5.7	7,999	5.7	6,181	5.5
Preopening and acquisition expenses	845	1.1	538	0.9	1,358	1.0	954	0.8
Closing and disposition expenses	14	0.0	(264)	(0.5)	104	0.1	734	0.7
Depreciation and amortization	2,029	2.6	1,334	2.3	3,808	2.7	2,625	2.3
Total Costs and Expenses	73,300	93.1	54,607	93.2	131,903	93.7	107,006	95.0
Income from Operations	5,416	6.9	3,989	6.8	8,828	6.3	5,643	5.0
Other Expense (Income)								
Interest expense	1,514	1.9	753	1.3	2,170	1.5	1,475	1.3
Other (income) expense	(978)	(1.2)	4	0.0	(924)	(0.7)	152	0.1
Total Other Expense	535	0.7	757	1.3	1,246	0.9	1,628	1.4
Income Before Income Taxes	4,881	6.2	3,232	5.5	7,582	5.4	4,016	3.6
Income Tax Expense	1,892	2.4	1,172	2.0	2,726	1.9	1,414	1.3
Consolidated Net Income	2,989	3.8	2,060	3.5	4,855	3.4	2,601	2.3
Less Consolidated Net Gain Attributable to Noncontrolling Interest in Variable Interest Entities	16	0.0	-	-	13	0.0	-	-
Consolidated Net Income Attributable to Controlling Interest	\$ 2,973	3.8%	\$ 2,060	3.5%	\$ 4,843	3.4%	\$ 2,601	2.3%

## **Food and Beverage Revenue**

For the three months ended July 2, 2017, revenues increased 34.3% to \$78.7 million from \$58.6 million in the three months ended July 3, 2016. In the six months ended July 2, 2017, revenues increased 24.9%, to \$140.7 million from \$112.7 million in the six months ended July 3, 2016.

The Company's Wendy's restaurants reported sales of \$74.9 million and \$133.4 million in the three and six months ended July 2, 2017, representing increases of 36.1% and 25.9%, respectively, over the same period in the prior year. The most significant contributing factor to the increase was a full quarter of sales from the 18 Wendy's restaurants acquired in 2016 and the acquisition of 69 Wendy's restaurants in the first six months of 2017. The Company's Wendy's restaurants experienced "same store sales" increases of 3.6% in the second quarter of 2017 and 3.8% in the first half of 2017 over prior year's sales.

The Company's casual dining restaurants reported sales of \$3.8 million and \$7.3 million in the three and six months ended July 2, 2017, representing increases of 6.9% and 9.3%, respectively, over the same period in the prior year. The increase is mainly due to the opening of the Company's new casual dining restaurant, Wheelhouse Kitchen & Cocktails, in May 2016. The Company's casual dining restaurants experienced "same store sales" decreases of 3.7% and 6.3%, respectively over prior year's sales, reflecting an overall national downward trend in the casual dining segment, as well as increased competitive intrusion.

## **Cost of Food and Beverages**

Food and beverage costs as a percent of revenues were 26.9% and 26.4% in the three and six months ended July 2, 2017 compared to 26.2% and 26.3% in the same periods in the prior year. The increase in cost of food and beverages as a percentage of revenues was primarily due to a nation-wide Wendy's value meal promotion, "Four-for-Four", which offered four items for four dollars, partially offset by a slight decline in average beef costs. Average beef costs decreased 3.1% to \$1.86 per pound for the three months ended July 2, 2017 from \$1.92 per pound for the three months ended July 3, 2016. Comparably, beef costs decreased 9.4% to \$1.74 per pound for the six months ended July 2, 2017, from \$1.92 per pound for the six months ended July 3, 2016.

## **Labor and Related Expenses**

Labor and related expenses decreased to 28.3% and 28.7% of revenues for the three and six months ended July 2, 2017 from 29.2% and 29.6% of revenues in the same period in the prior year. The decrease in labor as a percentage of revenue is primarily attributed to the implementation of new labor policies and practices, as well as an overall decline in insurance costs.

## **Other Operating Expenses**

Other operating expenses decreased as a percentage of revenues to 24.4% and 24.9% for the three and six months ended July 2, 2017 from 25.1% and 25.6% in the three and six months ended July 3, 2016. The decrease is partially related to increased sales in 2017, resulting in a dilutive impact of fixed costs as a percentage of sales, such as utilities and rent.

## General and Administrative Expenses

General and administrative expenses remained relatively consistent as a percent of revenues when compared to the prior year.

## Preopening and Acquisition Expenses

Preopening and acquisition expenses primarily represent costs associated with acquisitions and numerous reimagining efforts.

## Closing and Disposition Expenses

Closing and disposition expenses represent actual and estimated costs related to the closure of under-performing restaurants. Included in the second quarter 2016 is a credit resulting from the final settlement of a property closed in the prior year. Closing and disposition expenses are expected to be an ongoing expense from continuing efforts to improve our overall restaurant portfolio.

## Interest Expense

The increase in interest expense is due to financings associated with the recent acquisitions, as well as the accounting impact of the change in the fair value of the swap agreements.

## Other Income

Other income was primarily related to gains on purchase options and real estate transactions completed in the first six months of 2017.

## Income Tax Expense

Income tax expense is summarized below.

	Three Months Ended (000's)		Six Months Ended (000's)	
	7/2/2017	7/3/2016	7/2/2017	7/3/2016
Federal income tax expense	481	248	929	533
State and local income tax expense	480	132	714	286
Change in deferred tax asset	931	792	1,083	595
Income tax expense	<u>\$ 1,892</u>	<u>\$ 1,172</u>	<u>\$ 2,726</u>	<u>\$ 1,414</u>

## Financial Condition

Management monitors short and long-term cash needs and believes at this time, that with its ongoing operations and current cash balances, the Company has sufficient capital to meet its ongoing obligations. Loan covenants of the Company's various loan agreements include requirements for the maintenance of certain financial ratios. At July 2, 2017, the Company was in compliance with these requirements.

## Off-Balance Sheet Arrangements

There were no off-balance sheet arrangements as of July 2, 2017.

**Item 5      Legal proceedings.**

The Company is involved in various routine legal proceedings that are incidental to its business. All of these proceedings arose in the ordinary course of the Company's business and, in the opinion of the Company, any potential liability of the Company with respect to these legal proceedings will not, in the aggregate, be material to the Company's consolidated financial statements. The Company maintains various types of insurance standard to the industry that, subject to deductibles, will insure over many claims and legal proceedings brought against the Company.

**Item 6      Defaults upon senior securities.**

None.

**Item 7      Other information.**

None.

**Item 8      Exhibits.**

None.

## Item 9 Certifications.

I, Robert E. Schermer, Jr., Chief Executive Officer, certify that:

1. I have reviewed this quarterly disclosure statement of Meritage Hospitality Group Inc.;
2. Based on my knowledge, this disclosure statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this disclosure statement; and
3. Based on my knowledge, the financial statements, and other financial information included or incorporated by reference in this disclosure statement, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this disclosure statement.

August 16, 2017



Robert E. Schermer, Jr.  
Chief Executive Officer

I, Tracey A. Smith, Chief Financial Officer, certify that:

1. I have reviewed this quarterly disclosure statement of Meritage Hospitality Group Inc.;
2. Based on my knowledge, this disclosure statement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this disclosure statement; and
3. Based on my knowledge, the financial statements, and other financial information included or incorporated by reference in this disclosure statement, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this disclosure statement.

August 16, 2017



Tracey A. Smith  
Chief Financial Officer

## FORWARD-LOOKING STATEMENTS

*Certain statements contained in this report that are not historical facts constitute forward-looking statements. These may be identified by words such as “estimates,” “anticipates,” “hopes,” “projects,” “plans,” “expects,” “believes,” “should,” and similar expressions, and by the context in which they are used. Such statements are based only upon current expectations of the Company. Any forward-looking statement speaks only as of the date made. Reliance should not be placed on forward-looking statements because they involve known and unknown risks, uncertainties and other factors which may cause actual results, performance or achievements to differ materially from those expressed or implied. Meritage undertakes no obligation to update any forward-looking statements to reflect events or circumstances after the date on which they are made.*

*Statements concerning expected financial performance, business strategies and action which Meritage intends to pursue to achieve its strategic objectives, constitute forward-looking information. Implementation of these strategies and achievement of such financial performance are subject to numerous conditions, uncertainties and risk factors, which could cause actual performance to differ materially from the forward-looking statements. These include, without limitation: competition; changes in the national or local economy; changes in consumer tastes and eating habits; concerns about the nutritional quality of our restaurant menu items; concerns about consumption of beef or other menu items due to diseases; promotions and price discounting by competitors; severe weather; changes in travel patterns; road construction; demographic trends; the cost of food, labor and energy; the availability and cost of suitable restaurant sites; the ability to finance expansion; interest rates; insurance costs; the availability of adequate managers and hourly-paid employees; directives issued by the franchisor regarding operations and menu pricing; the general reputation of Meritage’s and its franchisors’ restaurants; the relationship between Meritage and its franchisors; legal claims; credit card fraud; and the recurring need for renovation and capital improvements. Meritage is also subject to extensive government regulations relating to, among other things, zoning, public health, sanitation, alcoholic beverage control, environment, food preparation, minimum and overtime wages and tips, employment of minors, citizenship requirements, working conditions, and the operation of its restaurants. Because Meritage’s operations are concentrated in certain areas of Michigan, Florida, Georgia, North and South Carolina, Virginia, Ohio, Oklahoma, Arkansas, Mississippi, Missouri, and Tennessee, significant economic changes in these states, or in the local economies where our restaurants are located, could adversely affect our operations. Additionally, with Meritage’s expansion, the Company could be adversely affected by tropical storms, hurricanes, or tornadoes. The Company’s news releases and public reports are not intended to constitute an offer to sell or a solicitation of an offer to buy any securities of the Company or otherwise engage in a transaction with the Company.*



# **Meritage Hospitality Group Inc. and Subsidiaries**

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**Consolidated Financial Report  
July 2, 2017 and July 3, 2016**

# Meritage Hospitality Group Inc. and Subsidiaries

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# Meritage Hospitality Group Inc. and Subsidiaries

## Consolidated Balance Sheet (unaudited)

	July 2, 2017	January 1, 2017
<b>Assets</b>		
<b>Current Assets</b>		
Cash	\$ 21,157,497	\$ 9,835,808
Receivables	1,140,051	739,023
Inventories	2,202,080	1,547,208
Prepaid expenses and other current assets	3,814,231	1,371,945
Total Current Assets	28,313,859	13,493,984
<b>Property and Equipment - Net</b>	98,035,915	64,503,125
<b>Goodwill</b>	90,537,390	48,228,488
<b>Intangible Assets</b>	1,582,014	841,397
<b>Deferred Income Taxes</b>	-	876,168
<b>Other Assets</b>		
Notes receivable	548,215	548,215
Long-term investments	5,558,392	5,503,002
Deposits and other assets	3,884,196	3,028,245
Total Assets	<b>\$ 228,459,981</b>	<b>\$ 137,022,624</b>
<b>Liabilities and Equity</b>		
<b>Current Liabilities</b>		
Trade accounts payable	\$ 11,829,407	\$ 10,356,673
Lines of credit	44,328,163	14,303,182
Current portion of long-term debt	9,154,425	5,367,229
Accrued liabilities	13,245,344	9,473,109
Total Current Liabilities	78,557,339	39,500,193
<b>Unearned Vendor Allowances</b>	4,372,267	225,358
<b>Accrued Rent</b>	3,227,972	3,092,784
<b>Other long-term Liabilities</b>	4,184,226	2,958,985
<b>Long-term Debt - Net of current portion</b>	93,060,732	55,932,940
<b>Deferred Income Taxes</b>	207,217	-
<b>Deferred Gain - Sale and leaseback transactions</b>	9,977,815	9,185,957
<b>Equity</b>	34,872,413	26,126,407
Total Liabilities and Equity	<b>\$ 228,459,981</b>	<b>\$ 137,022,624</b>

See notes to consolidated financial statements

# Meritage Hospitality Group Inc. and Subsidiaries

## Consolidated Statement of Operations (unaudited)

	Three Months Ended	
	July 2, 2017	July 3, 2016
<b>Food and Beverage Revenue</b>	\$ 78,715,356	\$ 58,596,928
<b>Costs and Expenses</b>		
Cost of food and beverages	21,149,618	15,357,259
Labor and related expenses	22,285,595	17,089,969
Advertising expenses	3,335,461	2,504,617
Other operating expenses	19,232,693	14,729,189
Total Operating Expenses	66,003,367	49,681,034
General and administrative expenses	4,407,954	3,318,312
Preopening and acquisition expenses	845,382	537,796
Closing and disposition expenses	14,116	(263,814)
Depreciation and amortization	2,028,856	1,334,143
Total Costs and Expenses	73,299,675	54,607,471
<b>Income from Operations</b>	5,415,681	3,989,457
<b>Other Expense (Income)</b>		
Interest expense	1,513,517	752,750
Other (income) expense	(978,448)	4,306
Total Other Expense	535,069	757,056
<b>Income Before Income Taxes</b>	4,880,612	3,232,401
<b>Income Tax Expense</b>	1,891,612	1,172,406
<b>Consolidated Net Income</b>	<b>\$ 2,989,000</b>	<b>\$ 2,059,995</b>
<b>Less Consolidated Net Income Attributable to Noncontrolling Interest in Variable Interest Entities</b>	15,573	-
<b>Consolidated Net Income Attributable to Controlling Interest</b>	<b>\$ 2,973,427</b>	<b>\$ 2,059,995</b>

See notes to consolidated financial statements

# Meritage Hospitality Group Inc. and Subsidiaries

## Consolidated Statement of Operations (unaudited)

	Six Months Ended	
	July 2, 2017	July 3, 2016
<b>Food and Beverage Revenue</b>	\$ 140,730,642	\$ 112,649,615
<b>Costs and Expenses</b>		
Cost of food and beverages	37,213,965	29,595,962
Labor and related expenses	40,380,213	33,379,605
Advertising expenses	5,953,728	4,744,684
Other operating expenses	35,086,275	28,792,085
Total Operating Expenses	118,634,181	96,512,336
General and administrative expenses	7,999,082	6,180,881
Preopening and acquisition expenses	1,357,692	954,120
Closing and disposition expenses	104,192	733,998
Depreciation and amortization	3,807,557	2,625,097
Total Costs and Expenses	131,902,704	107,006,432
<b>Income from Operations</b>	8,827,938	5,643,183
<b>Other Expense (Income)</b>		
Interest expense	2,169,938	1,475,455
Other (income) expense	(923,545)	152,070
Total Other Expense	1,246,393	1,627,525
<b>Income Before Income Taxes</b>	7,581,545	4,015,658
<b>Income Tax Expense</b>	2,726,413	1,414,354
<b>Consolidated Net Income</b>	<b>\$ 4,855,132</b>	<b>\$ 2,601,304</b>
<b>Less Consolidated Net Income Attributable to Noncontrolling Interest in Variable Interest Entities</b>	12,597	-
<b>Consolidated Net Income Attributable to Controlling Interest</b>	<b>\$ 4,842,535</b>	<b>\$ 2,601,304</b>

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	Series C Convertible Preferred Stock	Common Stock	Additional Paid-In Capital	Retained Earnings	Noncontrolling Interest	Total
<b>Balance - January 3, 2016</b>	<u>\$ 295</u>	<u>\$ 8,560</u>	<u>\$ -</u>	<u>\$ 56,512</u>	<u>\$ 17,845,000</u>	<u>\$ 2,622,990</u>	<u>\$ -</u>	<u>\$ 20,533,357</u>
Net income						6,449,978		6,449,978
Issuance of 322,472 shares of common stock				3,225	179,365			182,590
Preferred stock conversion		(32)		57	(25)			-
Common stock dividends					(409,776)			(409,776)
Preferred stock dividends					(710,108)			(710,108)
Company owned stock					(476,525)			(476,525)
Stock option expense					556,891			556,891
<b>Balance - January 1, 2017</b>	<u>\$ 295</u>	<u>\$ 8,528</u>	<u>\$ -</u>	<u>\$ 59,794</u>	<u>\$ 16,984,822</u>	<u>\$ 9,072,968</u>	<u>\$ -</u>	<u>\$ 26,126,407</u>
Net income						4,842,535	12,597	4,855,132
Issuance of 29,549 shares of common stock				295	35,660			35,955
Issuance of 170,360 shares of preferred stock			1,704		3,952,245			3,953,949
Preferred stock conversion	(295)	(240)		852	(317)			-
Common stock dividends					(272,461)			(272,461)
Preferred stock dividends					(440,696)			(440,696)
Company owned stock					(252,106)			(252,106)
Stock option expense					366,233			366,233
Contributed Capital							500,000	500,000
<b>Balance - July 2, 2017</b>	<u>\$ -</u>	<u>\$ 8,288</u>	<u>\$ 1,704</u>	<u>\$ 60,941</u>	<u>\$ 20,373,380</u>	<u>\$ 13,915,503</u>	<u>\$ 512,597</u>	<u>\$ 34,872,413</u>

See notes to consolidated financial statements

# Meritage Hospitality Group Inc. and Subsidiaries

## Consolidated Statement of Cash Flows (unaudited)

	Six Months Ended	
	July 2, 2017	July 3, 2016
<b>Cash Flows from Operating Activities</b>		
Net Income	\$ 4,855,132	\$ 2,601,304
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	3,807,557	2,625,097
Amortization of financing costs	115,743	77,502
Deferred income taxes	1,083,385	594,779
Amortization of deferred gain from sale and leaseback transactions	(438,176)	(445,014)
Change in fair market value of swap	111,592	-
Compensation paid by issuance of common stock	35,955	17,975
Gain on company owned stock	(252,106)	-
Loss on disposal of fixed assets	650,884	418,202
Stock option expense	366,233	251,079
Changes in operating assets and liabilities which provided (used) cash:		
Receivables	(401,028)	152,568
Inventories	38,128	6,549
Prepaid expenses and other current assets	(2,334,855)	(43,231)
Deposits and other assets	(861,805)	(1,007,704)
Accounts payable	1,472,734	(3,401,254)
Accrued liabilities	3,269,991	(622,999)
Other long-term liabilities	1,113,649	817,798
Accrued rent	135,188	155,909
Unearned vendor allowances	3,229,500	1,166,385
Net cash provided by operating activities	15,997,701	3,364,945
<b>Cash Flows from Investing Activities</b>		
Purchase of property and equipment	(39,235,540)	(7,424,707)
Purchase of intangible assets	(783,000)	(40,000)
Change in long-term investments	(55,390)	(55,780)
Capital contribution into variable interest entity	500,000	-
Acquisitions, net	(47,139,681)	(5,670,650)
Net cash used in investing activities	(86,713,611)	(13,191,137)

See notes to consolidated financial statements

# Meritage Hospitality Group Inc. and Subsidiaries

## Consolidated Statement of Cash Flows (unaudited) Continued

	Six Months Ended	
	July 2, 2017	July 3, 2016
<b>Cash Flows from Financing Activities</b>		
Proceeds from long-term debt	44,190,000	10,716,872
Proceeds from lines of credit - net	35,381,835	1,866,010
Proceeds from sale leaseback transactions	7,972,581	6,170,157
Principal payments on long-term debt	(2,831,904)	(3,663,634)
Principal payments on capital leases	(163,906)	(127,482)
Payments on line of credit related to sale leaseback transactions	(5,356,854)	(5,107,063)
Payments of financing costs	(394,945)	(15,954)
Proceeds from sale of common stock	-	95,325
Proceeds from issuance of preferred stock	3,953,949	-
Common stock dividends paid	(272,461)	(172,348)
Preferred stock dividends paid	(440,696)	(355,684)
Net cash provided from financing activities	82,037,599	9,406,199
<b>Net Increase (Decrease) in Cash</b>	11,321,689	(419,993)
<b>Cash - Beginning of year</b>	9,835,808	6,587,845
<b>Cash - End of period</b>	<u>\$ 21,157,497</u>	<u>\$ 6,167,852</u>
<b>Supplemental Disclosure of Cash Flow Information</b>		
Cash paid for:		
Interest	\$ 1,863,792	\$ 1,418,128
Income taxes	\$ 1,024,432	\$ 371,949
Significant non-cash investing and financing transactions:		
Deferred gain on sale leaseback transactions	\$ 1,230,034	\$ 975,845

See notes to consolidated financial statements



# Meritage Hospitality Group Inc. and Subsidiaries

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## Notes to Consolidated Financial Statements (unaudited)

### Note 1 - Consolidation

The consolidated financial statements include the accounts of Meritage Hospitality Group Inc., all of its wholly owned subsidiaries, its 98.5% owned subsidiary, RDG-MHG, LLC., ("RDG"), and its variable interest entity (VIE), Restaurant Holdings, LLC (Restaurant Holdings), for which the Company is the primary beneficiary.

RDG is a 15% partner in TRG-Meritage Bahamas, LLC., ("TRG"). Restaurant Holdings and the attributable equity is reported as a noncontrolling interest in the accompanying consolidated financial statements. For the purpose of consolidation, the effects of eliminations of revenue and expense due to intercompany transactions between the Company and Holdings are attributed to the Company. All intercompany transactions and balances have been eliminated in consolidation.

Restaurant Holdings is treated as a partnership for federal income tax purposes. Consequently, federal income taxes are not payable or provided for by Holdings. Restaurant Holdings LLC's members are taxed individually on their pro-rata ownership share of its earnings. Restaurant Holdings' net income or loss is allocated among the members in accordance with the Restaurant Holdings operating agreement.

### Note 2 - Stockholders' Equity

The Company has 5,000,000 authorized shares of \$0.01 par value per share preferred stock. 1,350,000 shares are designated as Series B convertible cumulative preferred stock, with 828,877 shares issued and outstanding as of July 2, 2017 and 852,250 shares issued and outstanding as of January 2, 2017. 1,500,000 shares are designated as Series C convertible cumulative preferred stock, with 170,360 shares issued and outstanding as of July 2, 2017 and 0 shares issued and outstanding as of January, 2 2017.

As of January 2, 2017, 29,520 shares of designated Series A convertible cumulative preferred stock were issued and outstanding. The Company exercised its right to convert 29,520 shares of Series A preferred shares to common stock in February 2017. Shares were converted at a conversion rate of \$7.00 per share, resulting in the issuance of 42,170 common shares. As of July 2, 2017, there were zero shares designated as Series A stock.

The Company raised \$3,953,948, net of fees, from issuing 170,360 shares of Series C cumulative convertible preferred stock in February 2017.

The Company has 30,000,000 authorized shares of \$0.01 par value per share common stock, with 6,094,127 and 5,979,371 shares issued and outstanding as of July 2, 2017 and January 1, 2017, respectively.

# Meritage Hospitality Group Inc. and Subsidiaries

## Notes to Unaudited Consolidated Financial Statements

### Note 3 - Acquisition of Wendy's Restaurants

The Company acquired eight Wendy's restaurants in March 2017. All restaurants acquired included the business and equipment. The Company acquired certain properties and leased the remaining. The Company entered into new lease agreements for certain 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 \$10,232,000 of new debt, net of cash received of \$299,000. The transaction resulted in the recording of approximately \$2,891,000 of goodwill, \$6,813,000 of land and building, \$600,000 of equipment, \$85,000 of inventory and \$455,000 of liabilities.

The Company acquired four Wendy's restaurants in April 2017. All restaurants acquired included the business and equipment. The Company acquired certain properties and leased the remaining. The Company entered into new lease agreements for certain 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 \$5,014,000 of new debt, net of cash paid of \$49,000. The transaction resulted in the recording of approximately \$1,608,000 of goodwill, \$3,214,000 of land and building, \$350,000 of equipment, \$31,000 of inventory and \$139,000 of liabilities.

The Company acquired 57 Wendy's restaurants in May 2017. All restaurants acquired included the business and equipment. The Company acquired certain properties and leased the remaining. The Company entered into new lease agreements for certain 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 \$54,054,000 of new debt, net of cash paid of \$1,616,000. The transaction resulted in the recording of approximately \$37,810,000 of goodwill, \$15,833,000 of land and building, \$3,729,000 of equipment, \$578,000 of inventory and \$2,280,000 of liabilities.

### Note 4 - Sale Leasebacks

The Company completed four sale and leaseback transactions during the six months ended July 2, 2017. The Company netted proceeds of approximately \$7,973,000, and with such proceeds paid down indebtedness of \$5,357,000, and deposited \$2,623,000 into the Company's treasury. The Company recorded deferred gains of approximately \$1,230,000. 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 reimagine a portion of the Wendy's restaurants acquired in previous years by December 31, 2021. As of July 2, 2017, the Company has remaining estimated capital improvements of \$6,800,000 toward these efforts.

# Meritage Hospitality Group Inc. and Subsidiaries

## Notes to Unaudited Consolidated Financial Statements

### Note 6 - Information About Variable Interest Entity

Restaurant Holdings was formed to facilitate real estate transactions where the Company has potential monetary upside in future sale and leaseback transactions. This VIE is owned by related parties and not directly by the Company. Restaurant Holdings will leverage a credit facility with a bank other than the Company's senior lender, secured by its interest in the real estate. Restaurant Holdings has availability of borrowings of up to \$35,000,000. As of July 2, 2017 Restaurant Holdings had bank debt obligations totaling \$28,417,000. Restaurant Holdings is considered to be a variable interest entity because its assets are leased to the Company and these leases with the Company are the primary source of resources to service its obligations.

The economic structure of the Company's new senior credit facility requires 25% equity for real estate transactions, which the Company believes is dilutive to its long-term growth strategy. The purpose of Restaurant Holdings is to provide a new source of capital to fund the purchase of restaurant real estate. Restaurant Holdings, upon acquisition of real estate, will lease the restaurant to the Company and use rent revenue to pay the interest expense on its bank debt.

Included in the consolidated balance sheet as of July 2, 2017 are the following amounts related to Holdings.

	July 2 2017
Assets:	
Cash	\$ 704,956
Property and Equipment - net	28,581,416
Total Assets	<u>\$ 29,286,372</u>
Liabilities:	
Current liabilities	\$ 356,973
Revolving line of credit	28,416,802
Total Liabilities	<u>28,773,775</u>
Equity - Noncontrolling interest	512,597
Total Liabilities and Equity	<u>\$ 29,286,372</u>