POTBELLY CORP
Form 10-Q
November 05, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 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 September 28, 2014

OR

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

For the Transition Period from __________ to __________

Commission File Number: 001-36104

Potbelly Corporation

(Exact name of registrant as specified in its charter)

Delaware	**36-4466837**
(State or Other Jurisdiction of Incorporation)	**(IRS Employer Identification Number)**

222 Merchandise Mart Plaza, 23rd Floor

Chicago, Illinois 60654

(Address, including Zip Code, of Principal Executive Offices)

Registrant s telephone number, including area code: (312) 951-0600

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 x 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

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

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

Common stock, $0.01 Par Value 28,965,043 shares as of October 31, 2014

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POTBELLY CORPORATION

QUARTERLY REPORT ON FORM 10-Q

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PART I. FINANCIAL INFORMATION.

ITEM 1. FINANCIAL STATEMENTS.

POTBELLY CORPORATION AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(amounts in thousands, except share and par value data, unaudited)

	September 28, 2014		December 29, 2013	
ASSETS				
Current assets				
Cash and cash equivalents	$	69,403	$	69,579
Accounts receivable, net of allowances of $26 and $6 as of September 28, 2014 and December 29, 2013, respectively		4,563		2,991
Inventories		2,447		2,263
Prepaid expenses and other current assets		8,876		6,965
Total current assets		85,289		81,798
Property and equipment, net		83,401		78,983
Intangible assets, net		3,404		3,404
Goodwill		1,428		1,428
Deferred income taxes		17,181		17,297
Deferred expenses, net and other assets		3,147		3,170
Total assets	**$**	**193,850**	**$**	**186,080**
LIABILITIES AND EQUITY				
Current liabilities				
Accounts payable	$	3,317	$	2,078
Accrued expenses		17,802		16,337
Accrued income taxes		1,512		216
Current portion of long-term debt		74		74
Total current liabilities		22,705		18,705
Long-term debt, net of current portion		955		1,018
Deferred rent and landlord allowances		13,374		12,288
Other long-term liabilities		717		796
Total liabilities		37,751		32,807
Equity				
Common stock, $0.01 par value authorized, 200,000,000 shares; outstanding 29,043,925 and 29,148,029 shares as of September 28, 2014, and		295		291

December 29, 2013, respectively		
Warrants	909	909
Additional paid-in-capital	388,063	383,077
Treasury stock, held at cost, 471,290 and no shares as of September 28, 2014, and December 29, 2013, respectively	(5,797)	
Accumulated deficit	(227,576)	(231,232)
Total stockholders equity	155,894	153,045
Non-controlling interest	205	228
Total equity	156,099	153,273
Total liabilities and equity	**$ 193,850**	**$ 186,080**

See accompanying notes to the unaudited condensed consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Operations

(amounts in thousands, except share and per share data, unaudited)

	For the 13 Weeks Ended		For the 39 Weeks Ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
Revenues				
Sandwich shop sales, net	$ 84,340	$ 77,747	$ 241,131	$ 224,214
Franchise royalties and fees	335	274	1,045	737
Total revenues	84,675	78,021	242,176	224,951
Expenses				
Sandwich shop operating expenses				
Cost of goods sold, excluding depreciation	24,044	23,014	69,066	65,767
Labor and related expenses	23,772	21,223	68,637	62,217
Occupancy expenses	10,467	9,295	30,629	26,826
Other operating expenses	8,847	7,946	25,696	23,058
General and administrative expenses	7,623	8,293	24,310	24,298
Depreciation expense	5,039	4,460	14,540	13,284
Pre-opening costs	314	364	839	1,083
Impairment and loss on disposal of property and equipment	1,315	250	2,192	329
Total expenses	81,421	74,845	235,909	216,862
Income from operations	3,254	3,176	6,267	8,089
Interest expense	42	97	124	330
Other expense				2
Income before income taxes	3,212	3,079	6,143	7,757
Income tax expense	1,260	905	2,476	2,792
Net income	1,952	2,174	3,667	4,965
Net income attributable to non-controlling interest	5	9	11	24
Net income attributable to Potbelly Corporation	1,947	2,165	3,656	4,941
Dividend declared to common and preferred stockholders		(49,854)		(49,854)
Accretion of redeemable convertible preferred stock to maximum redemption value		(4,796)		(15,097)

Net income (loss) attributable to common stockholders	$	1,947	$	(52,485)	$	3,656	$	(60,010)
Net income (loss) per common share attributable to common stockholders:								
Basic	$	0.07	$	(12.29)	$	0.12	$	(14.12)
Diluted	$	0.06	$	(12.29)	$	0.12	$	(14.12)
Weighted average shares outstanding:								
Basic		29,358,822		4,268,953		29,284,058		4,250,819
Diluted		30,044,456		4,268,953		30,463,093		4,250,819

See accompanying notes to the unaudited condensed consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Redeemable Convertible Preferred Stock and Equity (Deficit)

(amounts in thousands, except share data, unaudited)

Redeemable Convertible Preferred Stock

B	Series C		Series D		Series E		Series F		Total	
Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
$ 46,983	1,646,595	$ 23,715	1,250,000	$ 18,319	4,194,366	$ 79,861	2,007,743	$ 28,669	16,086,375	$ 250,343
3,188		1,609		1,251		3,523		1,944		15,097
$ 50,171	**1,646,595**	**$ 25,324**	**1,250,000**	**$ 19,570**	**4,194,366**	**$ 83,384**	**2,007,743**	**$ 30,613**	**16,086,375**	**$ 265,440**

See accompanying notes to the unaudited condensed consolidated financial statements.

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POTBELLY CORPORATION AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(amounts in thousands, unaudited)

	For the 39 Weeks Ended September 28, 2014	For the 39 Weeks Ended September 29, 2013
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 3,667	$ 4,965
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	14,540	13,284
Deferred income tax	116	1,683
Deferred rent and landlord allowances	1,086	258
Stock compensation expense	2,022	2,370
Asset impairment and loss on disposal of property and equipment	2,192	329
Amortization of debt issuance costs	53	46
Changes in operating assets and liabilities:		
Accounts receivable, net	(1,572)	(735)
Inventories	(184)	(215)
Prepaid expenses and other assets	(2,125)	(1,475)
Accounts payable	1,235	602
Accrued and other liabilities	2,264	3,267
Net cash provided by operating activities	23,294	24,379
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(20,544)	(21,265)
Net cash (used in) investing activities	(20,544)	(21,265)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from exercise of Series F warrants		2
Proceeds from exercise of stock options	3,780	
Payment of payroll taxes related to stock-based compensation awards	(812)	
Treasury stock repurchase	(5,797)	
Payment of costs associated with initial public offering		(533)
Distribution to non-controlling interest	(34)	
Payments on note payable	(63)	(59)
Net cash (used in) financing activities	(2,926)	(590)
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(176)	2,524
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	69,579	22,595

CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	69,403	$	25,119
Supplemental cash flow information:				
Income taxes paid	$	867	$	727
Interest paid		124		261
Supplemental non-cash investing and financing activities:				
Unpaid liability for purchases of property and equipment	$	3,059	$	2,561
Accretion of redeemable convertible preferred stock to maximum redemption value	$		$	15,097
Accrued dividend payable	$		$	49,854

See accompanying notes to the unaudited condensed consolidated financial statements

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

(1) Organization and Other Matters

Business

Potbelly Corporation (the Company or Potbelly), through its wholly owned subsidiaries, operates Potbelly Sandwich Works sandwich shops in 23 states and the District of Columbia. As of September 28, 2014, the Company had 319 company-operated shops. During the 39 weeks ended September 28, 2014, the Company opened 23 new company-operated shops and closed no shops.

The Company also sells and administers franchises of new Potbelly Sandwich Works sandwich shops. The first domestic and international franchise locations administered by the Company opened during February 2011. As of September 28, 2014, 14 franchised shops were in operation domestically and 12 franchised shops were in operation internationally. During the 39 weeks ended September 28, 2014, the Company opened four franchised shops and closed one franchised shop.

Basis of Presentation

The unaudited condensed consolidated financial statements and notes herein should be read in conjunction with the audited consolidated financial statements of Potbelly Corporation and its subsidiaries and the notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 29, 2013. The unaudited condensed consolidated financial statements included herein have been prepared by the Company without audit, pursuant to the rules and regulations of the SEC regarding interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) have been condensed or omitted pursuant to the SEC s rules and regulations. In the opinion of management, all adjustments, which are of a normal and recurring nature (except as otherwise noted), that are necessary to present fairly the Company s financial position as of December 29, 2013 and September 28, 2014, its statement of operations for the 13 and 39 weeks ended September 29, 2013 and September 28, 2014 and its statement of cash flows for the 39 weeks ended September 29, 2013 and September 28, 2014 have been included. The consolidated statements of operations for the interim periods presented herein are not necessarily indicative of the results to be expected for the full year.

The Company does not have any components of other comprehensive income (loss) recorded within its consolidated financial statements, and, therefore, does not separately present a statement of comprehensive income (loss) in its consolidated financial statements.

Principles of Consolidation

The unaudited condensed consolidated financial statements include the accounts of Potbelly Corporation; its wholly owned subsidiary, Potbelly Illinois, Inc. (PII); PII s wholly owned subsidiaries, Potbelly Franchising, LLC, Potbelly Sandwich Works, LLC (LLC) and 16 of LLC s wholly owned subsidiaries and the LLC s two joint ventures, collectively, the Company. All significant intercompany balances and transactions have been eliminated in consolidation. For the Company s consolidated joint ventures, non-controlling interest represents the non-controlling partners share of the assets, liabilities and operations related to their respective joint venture investments. The Company has ownership interests ranging from 65-75% in these consolidated joint ventures.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions, primarily related to long-lived assets, income taxes, stock-based compensation and common stock equity valuations, that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Fiscal Year

The Company uses a 52/53-week fiscal year that ends on the last Sunday of the calendar year. Approximately every five or six years a 53rd week is added. Fiscal 2013 and 2014 each consist of 52 weeks. The fiscal quarters ended September 29, 2013 and September 28, 2014 each consisted of 13 weeks.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

(2) Fair Value Measurements

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and all other current liabilities approximate fair values due to the short maturities of these balances.

The Company assesses potential impairments to its long-lived assets, which includes property and equipment, whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Shop-level assets are grouped at the individual shop-level for the purpose of the impairment assessment. Recoverability of an asset is measured by a comparison of the carrying amount of an asset to its estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of the shop assets was determined using the discounted future cash flow method of anticipated cash flows through the shop s lease-end date using fair value measurement inputs classified as Level 3. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. After performing a periodic review of our shops during each quarter of 2014, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance of shop profitability. We performed an impairment analysis related to these shops and recorded impairment charges of $1.3 million and $2.1 million for the 13 and 39 weeks ended September 28, 2014, respectively, related to the excess of the carrying amounts recorded on our balance sheet over the identified shops estimated fair values.

In the third fiscal quarter of 2014, the Company established a non-qualified deferred compensation plan, Potbelly Non-Qualified Deferred Compensation Plan, which allows highly compensated employees to defer a portion of their base salary and variable compensation each plan year. The Company maintains a rabbi trust to fund obligations under the deferred compensation plan. Amounts in the rabbi trust are invested in mutual funds. The investments in the rabbi trust are designated as trading securities and carried at fair value. Fair market value of investments in the rabbi trust is measured using Level 1 inputs (quoted prices for identical assets in active markets). As of September 28, 2014, the fair value of the investments in the rabbi trust was $16 thousand, which is included in other assets in the condensed consolidated balance sheet. The Company records trading gains and losses in general and administrative expenses in the condensed consolidated statement of operations, along with the offsetting amount related to the increase or decrease in deferred compensation to reflect its exposure to liabilities for payment under the deferred plan. For the three months ended September 28, 2014, the Company recorded an immaterial amount of unrealized losses on investments held in the rabbi trust.

(3) Earnings per share

Basic income (loss) per common share attributable to common stockholders is calculated using the weighted average number of common shares outstanding for the period. For the 13 and 39 weeks ended September 29, 2013, diluted (loss) per common share attributable to common stockholders was computed by dividing the (loss) allocated to common stockholders utilizing the two-class method by the weighted average number of fully diluted common shares outstanding. In periods with net income attributable to common stockholders, the Company s redeemable convertible preferred stock were all considered participating securities requiring the two-class method to calculate basic and diluted earnings per share. However, in periods of a net (loss) attributable to common stockholders, the redeemable convertible preferred stock were excluded from the computation of basic earnings per share due to the fact that they were not required to fund losses and the redemption amount was not reduced as a result of losses. For the 13 and 39 weeks ended September 29, 2013, the dilutive securities did not include stock options awarded to employees that had a performance condition requiring the completion of an initial public offering of common stock, as that performance condition was not satisfied at the reporting date and the holders of these options had no rights in our undistributed earnings until that time. On October 9, 2013, the Company completed an initial public offering. Effective upon the closing of such offering, all of the shares of preferred stock and non-voting common stock converted into common stock. As a result of the conversion, for subsequent reporting periods, the Company no longer utilized the two-class method in its calculation of diluted income (loss) per common share attributable to common stockholders. For the 13 and 39 weeks ended September 28, 2014, diluted income (loss) per common share attributable to common stockholders was calculated using income available to common shareholders divided by diluted weighted-average shares of common stock outstanding during the period.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

	For the 13 Weeks Ended		For the 39 Weeks Ended	
	September 28, 2014	September 29, 2013	September 28, 2014	September 29, 2013
Calculation of undistributed income (loss) for basic and diluted shares:				
Net income attributable to Potbelly Corporation	$ 1,947	$ 2,165	$ 3,656	$ 4,941
Less: Dividend declared to common and preferred stockholders		(49,854)		(49,854)
Less: Accretion of redeemable convertible preferred stock to maximum redemption value		(4,796)		(15,097)
Undistributed income (loss) for basic and diluted shares	$ 1,947	$ (52,485)	$ 3,656	$ (60,010)
Allocation of undistributed income (loss) to participating securities:				
Common shares	$ 1,947	$ (52,485)	$ 3,656	$ (60,010)
Redeemable convertible preferred shares				
Undistributed income (loss)	$ 1,947	$ (52,485)	$ 3,656	$ (60,010)
Weighted average common shares outstanding-basic	29,358,822	4,268,953	29,284,058	4,250,819
Plus: Effect of potential stock options exercise	602,982		1,054,632	
Plus: Effect of potential warrant exercise	82,652		124,403	
Weighted average common shares outstanding-diluted	30,044,456	4,268,953	30,463,093	4,250,819
Income (loss) per share available to common stockholders-basic	$ 0.07	$ (12.29)	$ 0.12	$ (14.12)
Income (loss) per share available to common stockholders-diluted	$ 0.06	$ (12.29)	$ 0.12	$ (14.12)
Potentially dilutive shares that are considered anti-dilutive:				

Common share options	869,317	4,744,664	537,318	4,744,664
Warrants		241,704		241,704

For the 13 and 39 weeks ended September 29, 2013, the Company s potential common stock instruments such as common stock options and warrants were not included in the computation of diluted (loss) per common share as the effect of including these shares in the calculation would have been anti-dilutive.

POTBELLY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

(4) Income Taxes

The Company recognized income tax expense of $2.5 million on pre-tax income of $6.1 million, or an effective tax rate of 40.3%, for the 39 weeks ended September 28, 2014, compared to income tax expense of $2.8 million on pre-tax income of $7.8 million or an effective tax rate of 36.0%, for the 39 weeks ended September 29, 2013. The difference between the statutory rate and the effective tax rate is primarily attributable to state income taxes offset by certain federal and state tax credits. The increase in the effective tax rate primarily relates to the expiration of certain federal income tax credits for 2014 that were available in prior years as well as provision to return adjustments.

(5) Capital Stock

On October 9, 2013, the Company completed an initial public offering. Effective upon the closing of such offering, all shares of preferred stock and non-voting common stock converted into common stock. The terms of the non-voting common stock provided that all shares of non-voting common stock would convert into voting common stock on a 1:1 basis immediately prior to the closing of an underwritten IPO or sale of the Company. The redeemable convertible preferred stock included down-round provisions which would adjust the conversion price for any additional stock issued without consideration or for a consideration per share less than the respective conversion price for one or more of the series of preferred stock in effect immediately prior to the issuance of such additional stock. Each share of common stock has the same relative rights and was identical in all respects to each other share of common stock. Each holder of shares of common stock is entitled to one vote for each share held by such holder at all meetings of stockholders.

On August 1, 2014, the Company s Board of Directors authorized a share repurchase program of up to $35.0 million of the Company s common stock. Under this program, the Company may, from time to time, purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Securities Exchange Act of 1934, as amended) or in privately negotiated transactions. During the 13 weeks ended September 28, 2014, the Company repurchased 471,290 shares of its common stock for approximately $5.8 million in open market transactions. As of September 28, 2014, the remaining dollar value of authorization under the share repurchase program was $29.2 million. Repurchased shares are included as treasury stock in the Condensed Consolidated Balance Sheets and the Condensed Consolidated Statements of Redeemable Convertible Preferred Stock and Equity.

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POTBELLY CORPORATION AND SUBSIDIARIES

Notes to Unaudited Condensed Consolidated Financial Statements

(6) Stock-Based Compensation

Throughout the 39 weeks ending September 28, 2014, the Company issued 292,767 stock options under the 2013 Long-Term Incentive Plan to eligible employees and key executives. The fair value of the options was determined using the Black-Scholes option pricing model. The weighted average common stock fair value of options granted during the 39 weeks ended September 28, 2014 was $19.58 per share, as estimated using the following weighted average assumptions: expected life of options seven years; volatility- 49.36%; risk-free interest rate 1.28%; and dividend yield 0.00%. The Company used the simplified method for determining the expected life of the options. Due to the lack of historical data as a newly public company, the Company calculated the specific stock price volatility using a blended volatility rate based on comparable publicly traded companies.

A summary of activity for the 39 weeks ended September 28, 2014 is as follows:

Options	**Shares (Thousands)**	**Weighted Average Exercise Price**	**Aggregate Intrinsic Value (Thousands)**	**Weighted Average Remaining Term (Years)**
Outstanding December 29, 2013	5,030	$ 9.41	$ 78,575	6.31
Granted	293	19.58		
Exercised	(339)	8.81		
Canceled	(105)	11.64		
Outstanding September 28, 2014	4,879	10.01	$ 12,136	5.81
Exercisable September 28, 2014	3,680	8.99	$ 11,910	5.94

During the 39 weeks ended September 28, 2014, the Company issued 28,240 shares of unrestricted common stock to certain non-employee members of its Board of Directors. The unrestricted stock had a weighted average grant-date share price of $15.29 upon issuance. The Company recorded $0.4 million in stock-based compensation expense, with a corresponding increase to additional paid-in capital, related to the issuance of common stock.

In accordance with ASC Topic 718, *Compensation Stock Compensation*, stock-based compensation is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense over the requisite employee service period, which is generally the vesting period of the grant, with a corresponding increase to additional paid-in-capital. For the 13 and 39 weeks ended September 28, 2014, the Company recognized stock-based compensation expense of $0.6 million and $2.0 million, respectively, which includes $32 thousand and $0.4 million related to the unrestricted common stock granted during 2014, respectively. For the 13 and 39 weeks ended September 29, 2013, the Company recognized stock-based compensation expense of $1.2 million and $2.4 million, respectively. As of September 28, 2014, the unrecognized stock-based compensation expense was $6.0 million, which will be recognized through fiscal year 2018. The Company records stock-based compensation expense within general and administrative expenses in the consolidated statements of operations.

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ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Forward-Looking Statements

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 29, 2013. This discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), and involves numerous risks and uncertainties. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and generally contain words such as believes, expects, may, will, should, seeks, intends, plans, strives, goal, estimates, forecasts, projects or anticipates or similar expressions. Our forward-looking statements are subject to risks and uncertainties, which may cause actual results to differ materially from those projected or implied by the forward-looking statement. Forward-looking statements are based on current expectations and assumptions and currently available data and are neither predictions nor guarantees of future events or performance. You should not place undue reliance on forward-looking statements, which speak only as of the date hereof. See Risk Factors and Cautionary Note Regarding Forward-Looking Statements included in our Annual Report on Form 10-K for the fiscal year ended December 29, 2013, for a discussion of factors that could cause our actual results to differ from those expressed or implied by forward-looking statements.

Overview

Potbelly is a fast-growing neighborhood sandwich concept offering toasty warm sandwiches, signature salads and other fresh menu items served by engaging people in an environment that reflects the Potbelly brand. Our combination of product, people and place is how we deliver on our passion to be The Best Place for Lunch. Our sandwiches, salads and hand-dipped milkshakes are all made fresh to order and our cookies are baked fresh each day. Our employees are trained to engage with our customers in a genuine way to provide a personalized experience. Our shops feature vintage design elements and locally-themed décor inspired by the neighborhood that we believe create a lively atmosphere. Through this combination, we believe we are creating a devoted base of Potbelly fans that return again and again and that we are expanding one sandwich shop at a time.

We believe that a key to our past and future success is our culture. It is embodied in *The Potbelly Advantage*, which is an expression of our Vision, Mission, Passion and Values, and the foundation of everything we do. Our Vision is for our customers to feel that we are their Neighborhood Sandwich Shop and to tell others about their great experience. Our Mission is to make people really happy, to make more money and to improve every day. Our Passion is to be The Best Place for Lunch. Our Values embody both how we lead and how we behave, and form the cornerstone of our culture. We use simple language that resonates from the frontline associate to the most senior levels of the organization, creating shared expectations and accountabilities in how we approach our day-to-day activities. We strive to be a fun, friendly and hardworking group of people who enjoy taking care of our customers, while at the same time taking care of each other.

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13 Weeks Ended September 28, 2014 Compared to 13 Weeks Ended September 29, 2013

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

	For the 13 Weeks Ended					
	September 28, 2014	% of Revenues	September 29, 2013	% of Revenues	Increase (Decrease)	Percent Change
Revenues						
Sandwich shop sales, net	$ 84,340	99.6%	$ 77,747	99.6%	$ 6,593	8.5%
Franchise royalties and fees	335	0.4	274	0.4	61	22.3
Total revenues	84,675	100.0	78,021	100.0	6,654	8.5
Expenses						
Sandwich shop operating expenses						
Cost of goods sold, excluding depreciation	24,044	28.4	23,014	29.5	1,030	4.5
Labor and related expenses	23,772	28.1	21,223	27.2	2,549	12.0
Occupancy expenses	10,467	12.4	9,295	11.9	1,172	12.6
Other operating expenses	8,847	10.4	7,946	10.2	901	11.3
General and administrative expenses	7,623	9.0	8,293	10.6	(670)	(8.1)
Depreciation expense	5,039	6.0	4,460	5.7	579	13.0
Pre-opening costs	314	0.4	364	0.5	(50)	(13.7)
Impairment and loss on disposal of property and equipment	1,315	1.6	250	0.3	1,065	426.0
Total expenses	81,421	96.2	74,845	95.9	6,576	8.8
Income from operations	3,254	3.8	3,176	4.1	78	2.5
Interest expense	42	*	97	0.1	(55)	(56.7)
Income before income taxes	3,212	3.8	3,079	3.9	133	4.3
Income tax expense	1,260	1.5	905	1.2	355	39.2
Net income	1,952	2.3	2,174	2.8	(222)	(10.2)
Net income attributable to non-controlling interests	5	*	9	*	(4)	(44.4)
Net income attributable to Potbelly Corporation	1,947	2.3	2,165	2.8	(218)	(10.1)
Dividend declared to common and preferred stockholders			(49,854)	(63.9)	49,854	100.0
Accretion of redeemable convertible preferred stock to maximum redemption value			(4,796)	(6.1)	4,796	100.0

Net income (loss) attributable to common stockholders	$	1,947	2.3%	$	(52,485)	(67.3)%	$ 54,432	103.7%

* Amount is less than 0.1%

Revenues

Total revenues increased by $6.7 million, or 8.5%, to $84.7 million during the 13 weeks ended September 28, 2014, from $78.0 million during the 13 weeks ended September 29, 2013. The increase in revenues primarily consisted of an increase of $6.2 million in sales from shops not yet in our company-operated comparable store sales base, a $0.1 million increase in franchise revenues and a $0.4 million, or 0.5%, increase in company-operated comparable store sales. The increase in company-operated comparable store sales resulted from an increase in average check from certain menu price increases and menu mix, partially offset by a reduction in traffic.

Cost of Goods Sold

Cost of goods sold increased by $1.0 million, or 4.5%, to $24.0 million during the 13 weeks ended September 28, 2014, compared to $23.0 million during the 13 weeks ended September 29, 2013, primarily due to the increase in revenues. As a percentage of revenues, cost of goods sold decreased to 28.4% during the 13 weeks ended September 28, 2014, from 29.5% during the 13 weeks ended September 29, 2013, primarily driven by certain menu price increases as well as volume-based rebates from certain vendors.

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Labor and Related Expenses

Labor and related expenses increased by $2.5 million, or 12.0%, to $23.8 million during the 13 weeks ended September 28, 2014, from $21.2 million during the 13 weeks ended September 29, 2013, primarily due to new shop openings. As a percentage of revenues, labor and related expenses increased to 28.1% during the 13 weeks ended September 28, 2014, from 27.2% during the 13 weeks ended September 29, 2013, primarily driven by incremental training and shop-level staffing investments, as well as wage inflation in certain states as a result of statutory minimum wage increases.

Occupancy Expenses

Occupancy expenses increased by $1.2 million, or 12.6%, to $10.5 million during the 13 weeks ended September 28, 2014, from $9.3 million during the 13 weeks ended September 29, 2013, primarily due to new shop openings. As a percentage of revenues, occupancy expenses increased to 12.4% during the 13 weeks ended September 28, 2014, from 11.9% during the 13 weeks ended September 29, 2013, due to increased rent as a result of lease extensions in certain legacy markets, as well as increases in other occupancy-related costs.

Other Operating Expenses

Other operating expenses increased by $0.9 million, or 11.3%, to $8.8 million during the 13 weeks ended September 28, 2014, from $7.9 million during the 13 weeks ended September 29, 2013. The increase is attributable to new shop openings and increased fees associated with higher credit card usage in our shops. As a percentage of revenues, other operating expenses increased to 10.4% during the 13 weeks ended September 28, 2014, from 10.2% during the 13 weeks ended September 29, 2013, primarily due to increased utility costs as well as various other operating expenses, partially offset by the $0.2 million cumulative adjustment recorded for the change in accounting estimate related to gift card breakage. Refer to Critical Accounting Policies and Estimates for additional information regarding the change in accounting estimate.

General and Administrative Expenses

General and administrative expenses decreased by $0.7 million, or 8.1%, to $7.6 million during the 13 weeks ended September 28, 2014, from $8.3 million during the 13 weeks ended September 29, 2013. The net decrease is driven primarily by lower labor-related costs and lower costs associated with being a public company, including costs associated with our IPO in the prior year, partially offset by costs associated with our plans to move our corporate headquarters. As a percentage of revenues, general and administrative expenses decreased to 9.0% during the 13 weeks ended September 28, 2014, from 10.6% during the 13 weeks ended September 29, 2013, driven by the factors above, coupled with sales leverage (*i.e.,* the ability to spread certain costs over a higher revenue base).

Depreciation Expense

Depreciation expense increased by $0.6 million, or 13.0%, to $5.0 million during the 13 weeks ended September 28, 2014, from $4.5 million during the 13 weeks ended September 29, 2013, primarily due to a higher depreciable base related to new shops and existing shop capital investments. As a percentage of revenues, depreciation increased to 6.0% during the 13 weeks ended September 28, 2014, from 5.7% during the 13 weeks ended September 29, 2013, driven partially from an increase in existing shop capital investments that have, on average, lower useful lives than new shops.

Pre-Opening Costs

Pre-opening costs decreased by $0.1 million, or 13.7%, to $0.3 million during the 13 weeks ended September 28, 2014, from $0.4 million during the 13 weeks ended September 29, 2013, primarily due to fewer new shops opened during the 13 weeks ended September 28, 2014 compared to the 13 weeks ended September 29, 2013.

Impairment and Loss on Disposal of Property and Equipment

Impairment and loss on disposal of property and equipment increased to $1.3 million during the 13 weeks ended September 28, 2014, from $0.3 million during the 13 weeks ended September 29, 2013. After performing a periodic review of our shops during the third quarter of 2014, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance of shop profitability. We performed an impairment analysis related to these shops and recorded an impairment charge of $1.3 million related to the excess of the carrying amounts recorded on our balance sheet over the identified shops estimated fair values.

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Interest Expense

Interest expense decreased by $55 thousand, or 56.7%, to $42 thousand during the 13 weeks ended September 28, 2014, from $0.1 million during the 13 weeks ended September 29, 2013, primarily due to repaying the $14.0 million outstanding under the senior credit facility on October 24, 2013. Interest expense for the 13 weeks ended September 28, 2014 is attributable to interest on the note payable, unused commitment fees and deferred financing fees.

Income Tax Expense

Income tax expense increased by $0.4 million to $1.3 million for the 13 weeks ended September 28, 2014, from $0.9 million during the 13 weeks ended September 29, 2013. For the 13 weeks ended September 28, 2014, our effective tax rate was 39.2%, compared to 29.4% for the 13 weeks ended September 29, 2013. The increase in the effective tax rate primarily relates to the expiration of certain federal income tax credits that were available in prior years, as well as certain provision to return adjustments recorded in the prior year.

39 Weeks Ended September 28, 2014 Compared to 39 Weeks Ended September 29, 2013

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

	For the 39 Weeks Ended					
	September 28, 2014	% of Revenues	September 29, 2013	% of Revenues	Increase (Decrease)	Percent Change
Revenues						
Sandwich shop sales, net	$ 241,131	99.6%	$ 224,214	99.7%	$ 16,917	7.5%
Franchise royalties and fees	1,045	0.4	737	0.3	308	41.8
Total revenues	242,176	100.0	224,951	100.0	17,225	7.7
Expenses						
Sandwich shop operating expenses						
Cost of goods sold, excluding depreciation	69,066	28.5	65,767	29.2	3,299	5.0
Labor and related expenses	68,637	28.3	62,217	27.7	6,420	10.3
Occupancy expenses	30,629	12.6	26,826	11.9	3,803	14.2
Other operating expenses	25,696	10.6	23,058	10.3	2,638	11.4
General and administrative expenses	24,310	10.0	24,298	10.8	12	*
Depreciation expense	14,540	6.0	13,284	5.9	1,256	9.5
Pre-opening costs	839	0.3	1,083	0.5	(244)	(22.5)
Impairment and loss on disposal of property and equipment	2,192	0.9	329	0.1	1,863	566.3
Total expenses	235,909	97.4	216,862	96.4	19,047	8.8

Income from operations	6,267	2.6	8,089	3.6	(1,822)	(22.5)
Interest expense	124	0.1	330	0.1	(206)	(62.4)
Other expense			2		(2)	(100.0)
Income before income taxes	6,143	2.5	7,757	3.4	(1,614)	(20.8)
Income tax expense	2,476	1.0	2,792	1.2	(316)	(11.3)
Net income	3,667	1.5	4,965	2.2	(1,298)	(26.1)
Net income attributable to non-controlling interests	11	*	24	*	(13)	(54.2)
Net income attributable to Potbelly Corporation	3,656	1.5	4,941	2.2	(1,285)	(26.0)
Dividend declared to common and preferred stockholders			(49,854)	(22.2)	49,854	100.0
Accretion of redeemable convertible preferred stock to maximum redemption value						