BRINKER INTERNATIONAL INC
Form 10-Q
May 05, 2014
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 26, 2014
Commission File Number 1-10275

BRINKER INTERNATIONAL, INC.
(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	75-1914582 (I.R.S. Employer Identification No.)
6820 LBJ FREEWAY, DALLAS, TEXAS (Address of principal executive offices)	75240 (Zip Code)

(972) 980-9917
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o
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 o
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 definition of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer	x		Accelerated filer	o
Non-accelerated filer	o	(Do not check if a smaller reporting company)	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 o No x
Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 28, 2014
Common Stock, $0.10 par value	64,951,528 shares

Table of Contents

BRINKER INTERNATIONAL, INC.
INDEX

Table of Contents

PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS
BRINKER INTERNATIONAL, INC.
Consolidated Balance Sheets
(In thousands, except share and per share amounts)
(Unaudited)

	March 26, 2014	June 26, 2013
ASSETS		
Current Assets:		
Cash and cash equivalents	$64,609	$59,367
Accounts receivable	43,476	44,082
Inventories	24,346	24,628
Prepaid expenses and other	62,725	65,584
Income taxes receivable	0	4,930
Total current assets	195,156	198,591
Property and Equipment, at Cost:		
Land	148,801	147,581
Buildings and leasehold improvements	1,470,583	1,435,426
Furniture and equipment	585,250	580,115
Construction-in-progress	24,039	20,588
	2,228,673	2,183,710
Less accumulated depreciation and amortization	(1,191,264)	(1,147,895)
Net property and equipment	1,037,409	1,035,815
Other Assets:		
Goodwill	133,163	142,103
Deferred income taxes	25,258	24,064
Other	59,092	52,030
Total other assets	217,513	218,197
Total assets	$1,450,078	$1,452,603
LIABILITIES AND SHAREHOLDERS’ EQUITY		
Current Liabilities:		
Current installments of long-term debt	$27,810	$27,596
Accounts payable	93,309	93,326
Accrued liabilities	283,830	268,444
Income taxes payable	10,796	0
Deferred income taxes	549	845
Total current liabilities	416,294	390,211
Long-term debt, less current installments	817,259	780,121
Other liabilities	128,419	132,914
Commitments and Contingencies (Note 9)		
Shareholders’ Equity:		
Common stock—250,000,000 authorized shares; $0.10 par value; 176,246,649 shares issued and 65,302,505 shares outstanding at March 26, 2014, and 176,246,649 shares issued and 67,444,099 shares outstanding at June 26, 2013	17,625	17,625
Additional paid-in capital	480,040	477,420
Accumulated other comprehensive income (loss)	(1,862)	0
Retained earnings	2,293,639	2,217,623
	2,789,442	2,712,668

Less treasury stock, at cost (110,944,144 shares at March 26, 2014 and 108,802,550 shares at June 26, 2013)	(2,701,336)	(2,563,311)
Total shareholders’ equity	88,106	149,357
Total liabilities and shareholders’ equity	$1,450,078	$1,452,603

See accompanying notes to consolidated financial statements.

3

BRINKER INTERNATIONAL, INC.
Consolidated Statements of Comprehensive Income
(In thousands, except per share amounts)
(Unaudited)

	Thirteen Week Periods Ended		Thirty-Nine Week Periods Ended	
	March 26, 2014	March 27, 2013	March 26, 2014	March 27, 2013
Revenues:				
Company sales	$739,200	$724,693	$2,088,087	$2,057,490
Franchise and other revenues	19,208	18,066	58,640	58,540
Total revenues	758,408	742,759	2,146,727	2,116,030
Operating costs and expenses:				
Company restaurants (excluding depreciation and amortization)				
Cost of sales	195,439	198,316	561,276	567,602
Restaurant labor	233,890	231,822	672,525	667,865
Restaurant expenses	171,574	164,537	508,405	489,781
Company restaurant expenses	600,903	594,675	1,742,206	1,725,248
Depreciation and amortization	34,218	33,222	100,912	98,830
General and administrative	34,009	33,986	98,792	102,289
Other gains and charges	2,088	1,550	4,315	2,227
Total operating costs and expenses	671,218	663,433	1,946,225	1,928,594
Operating income	87,190	79,326	200,502	187,436
Interest expense	7,068	7,085	21,128	21,040
Other, net	(693)	(573)	(1,736)	(2,096)
Income before provision for income taxes	80,815	72,814	181,110	168,492
Provision for income taxes	24,552	20,863	55,891	51,500
Net income	$56,263	$51,951	$125,219	$116,992
Basic net income per share	$0.85	$0.73	$1.88	$1.61
Diluted net income per share	$0.82	$0.71	$1.83	$1.56
Basic weighted average shares outstanding	66,479	71,067	66,661	72,511
Diluted weighted average shares outstanding	68,342	73,341	68,591	74,873
Other comprehensive income (loss):				
Foreign currency translation adjustment	$(1,108)	$0	$(1,862)	$0
Other comprehensive loss	(1,108)	0	(1,862)	0
Comprehensive income	$55,155	$51,951	$123,357	$116,992
Dividends per share	$0.24	$0.20	$0.72	$0.60

See accompanying notes to consolidated financial statements.

Table of Contents

BRINKER INTERNATIONAL, INC.
Consolidated Statements of Cash Flows
(In thousands)
(Unaudited)

	Thirty-Nine Week Periods Ended	
	March 26, 2014	March 27, 2013
Cash Flows from Operating Activities:		
Net income	$125,219	$116,992
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	100,912	98,830
Stock-based compensation	12,990	12,909
Deferred income taxes	(1,490)	(9,867)
Restructure charges and other impairments	3,836	3,792
Net loss on disposal of assets	3,208	1,115
(Gain) loss on equity investments	(353)	752
Other	355	205
Changes in assets and liabilities:		
Accounts receivable	2,820	5,543
Inventories	212	760
Prepaid expenses and other	4,115	1,586
Other assets	(1,694)	(2,367)
Accounts payable	4,168	(15,644)
Accrued liabilities	11,699	(4,617)
Current income taxes	14,043	12,893
Other liabilities	(2,940)	(246)
Net cash provided by operating activities	277,100	222,636
Cash Flows from Investing Activities:		
Payments for property and equipment	(113,980)	(98,690)
Proceeds from sale of assets	833	6,535
Net cash used in investing activities	(113,147)	(92,155)
Cash Flows from Financing Activities:		
Purchases of treasury stock	(191,811)	(191,799)
Borrowings on revolving credit facility	98,000	110,000
Payments on revolving credit facility	(40,000)	0
Payments of dividends	(47,556)	(42,161)
Excess tax benefits from stock-based compensation	17,972	7,811
Payments on long-term debt	(19,890)	(19,785)
Proceeds from issuances of treasury stock	24,574	32,042
Net cash used in financing activities	(158,711)	(103,892)
Net change in cash and cash equivalents	5,242	26,589
Cash and cash equivalents at beginning of period	59,367	59,103
Cash and cash equivalents at end of period	$64,609	$85,692

See accompanying notes to consolidated financial statements.

Table of Contents

BRINKER INTERNATIONAL, INC.
Notes to Consolidated Financial Statements
(Unaudited)

1. BASIS OF PRESENTATION

References to “Brinker,” “the Company,” “we,” “us” and “our” in this Form 10-Q are references to Brinker International, Inc. and its subsidiaries and any predecessor companies of Brinker International, Inc.

Our consolidated financial statements as of March 26, 2014 and June 26, 2013 and for the thirteen week and thirty-nine week periods ended March 26, 2014 and March 27, 2013 have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). We are principally engaged in the ownership, operation, development, and franchising of the Chili’s Grill & Bar (“Chili’s”) and Maggiano’s Little Italy (“Maggiano’s”) restaurant brands. At March 26, 2014, we owned, operated or franchised 1,608 restaurants in the United States and 31 countries and two territories outside of the United States.

Beginning in the third quarter of fiscal 2014, other comprehensive income is presented on the newly titled consolidated statements of comprehensive income. The foreign currency translation adjustment included in comprehensive income represents the unrealized impact of translating the financial statements of the Canadian entity from Canadian dollars, the functional currency, to U.S. dollars. This amount is not included in net income and would only be realized upon disposition of the business. The accumulated other comprehensive income (loss) is presented on the consolidated balance sheets. Additionally, certain prior year balances in the consolidated balance sheets have been reclassified to conform with fiscal 2014 presentation. These reclassifications have no effect on our net income as previously reported and an immaterial impact on our prior year consolidated balance sheets.

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and costs and expenses during the reporting period. Actual results could differ from those estimates.

The information furnished herein reflects all adjustments (consisting only of normal recurring accruals and adjustments) which are, in our opinion, necessary to fairly state the interim operating results for the respective periods. However, these operating results are not necessarily indicative of the results expected for the full fiscal year. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to SEC rules and regulations. The notes to the consolidated financial statements (unaudited) should be read in conjunction with the notes to the consolidated financial statements contained in the June 26, 2013 Form 10-K. We believe the disclosures are sufficient for interim financial reporting purposes.

2. ACQUISITION OF CHILI'S RESTAURANTS

On June 1, 2013, we completed the acquisition of 11 Chili's restaurants in Alberta, Canada from an existing franchisee for $24.6 million in cash. The results of operations of the Canadian restaurants are included in our consolidated financial statements from the date of acquisition. The assets and liabilities of the Canadian restaurants were recorded at their respective fair values as of the date of acquisition. During the first quarter of fiscal 2014, we completed the valuation of the reacquired franchise rights and recorded the asset at an estimated fair value of $8.9 million in other assets on the consolidated balance sheet, with a corresponding decrease to goodwill.

The excess of the purchase price over the aggregate fair value of net assets acquired was allocated to goodwill. We expect the majority of the goodwill balance to be deductible for tax purposes. The portion of the purchase price attributable to goodwill represents benefits expected as a result of the acquisition, including sales and unit growth opportunities. We do not expect any further material adjustments to the purchase price allocation. Pro-forma financial information of the combined entities for periods prior to the acquisition is not presented due to the immaterial impact of the financial results of the Canadian restaurants on our consolidated financial statements.

3. EARNINGS PER SHARE

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding for the reporting period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted earnings per share, the basic weighted average number of shares is increased by the dilutive effect of stock options and restricted share awards determined using the treasury stock method. We had approximately 119,000 stock options and restricted share awards outstanding

Table of Contents

at March 26, 2014 and 470,000 stock options and restricted share awards outstanding at March 27, 2013 that were not included in the dilutive earnings per share calculation because the effect would have been anti-dilutive.

4. LONG-TERM DEBT

Long-term debt consists of the following (in thousands):

	March 26, 2014	June 26, 2013
3.88% notes	$299,729	$299,707
2.60% notes	249,856	249,829
Term loan	193,750	212,500
Revolving credit facility	58,000	0
Capital lease obligations	43,734	45,681
	845,069	807,717
Less current installments	(27,810)	(27,596)
	$817,259	$780,121

During the first nine months of fiscal 2014, $98 million was drawn from the the revolver primarily to fund share repurchases. We repaid $40 million of the outstanding balance leaving $192 million of credit available under the revolver as of March 26, 2014.

The term loan and revolving credit facility bear interest of LIBOR plus an applicable margin, which is a function of our credit rating and debt to cash flow ratio, but is subject to a maximum of LIBOR plus 2.50%. Based on our current credit rating, we are paying interest at a rate of LIBOR plus 1.63%. One month LIBOR at March 26, 2014 was approximately 0.15%. Our debt agreements contain various financial covenants that, among other things, require the maintenance of certain leverage and fixed charge coverage ratios. We are currently in compliance with all financial covenants.

5. FAIR VALUE MEASUREMENTS

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.
- Level 3 – inputs are unobservable and reflect our own assumptions.

(a) Non-Financial Assets Measured on a Non-Recurring Basis

During fiscal 2014, long-lived assets with a carrying value of $2.6 million, primarily related to four underperforming restaurants, were written down to their fair value of $1.3 million resulting in an impairment charge of $1.3 million, which was included in other gains and charges in the consolidated statement of comprehensive income for the period. During fiscal 2013, long-lived assets with a carrying value of $0.8 million, primarily related to one underperforming restaurant, were written down to their fair value of $0.1 million resulting in an impairment charge of $0.7 million, which was included in other gains and charges in the consolidated statement of comprehensive income for the period. We determined fair value based on projected discounted future operating cash flows of the restaurants over their remaining service life using a risk adjusted discount rate that is commensurate with the risk inherent in our current business model.

Table of Contents

The following table presents fair values for those assets measured at fair value on a non-recurring basis at March 26, 2014 and March 27, 2013 (in thousands):

	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Total
Long-lived assets held for use				
At March 26, 2014	$0	$0	$1,342	$1,342
At March 27, 2013	$0	$0	$140	$140

(b) Other Financial Instruments

Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable and long-term debt. The fair values of cash and cash equivalents, accounts receivable and accounts payable approximate their carrying amounts because of the short maturity of these items. The fair values of the 2.60% notes and 3.88% notes are based on quoted market prices and are considered Level 1 fair value measurements. At March 26, 2014, the 2.60% notes had a carrying value of $249.9 million and a fair value of $248.2 million and the 3.88% notes had a carrying value of $299.7 million and a fair value of $279.8 million. At June 26, 2013, the 2.60% notes had a carrying value of $249.8 million and a fair value of $244.2 million and the 3.88% notes had a carrying value of $299.7 million and a fair value of $279.5 million. The carrying amount of debt outstanding pursuant to the term loan and revolving credit facility approximates fair value as interest rates on these instruments approximate current market rates (Level 2).

6. OTHER GAINS AND CHARGES

Other gains and charges consist of the following (in thousands):

	Thirteen Week Periods Ended		Thirty-Nine Week Periods Ended	
	March 26, 2014	March 27, 2013	March 26, 2014	March 27, 2013
Restaurant impairment charges	$0	$0	$1,285	$661
Restaurant closure charges	1,224	305	2,330	2,887
Severance and other benefits	717	1,269	1,110	1,269
Gains on the sale of assets, net	0	(81)	(579)	(2,430)
Other	147	57	169	(160)
	$2,088	$1,550	$4,315	$2,227

In the third quarter of fiscal 2014, we recorded $1.2 million of restaurant closure charges consisting primarily of lease termination charges and other costs associated with closed restaurants. Additionally, we incurred $0.7 million in severance and other benefits related to organization changes made during the third quarter. The severance charges include expense related to the accelerated vesting of stock-based compensation awards.

During the first nine months of fiscal 2014, we recorded restaurant impairment charges of $1.3 million related to underperforming restaurants that either continue to operate or are scheduled to close. We also recorded $2.3 million of restaurant closure charges consisting primarily of lease termination charges and incurred $1.1 million in severance and other benefits related to organizational changes. Additionally, a $0.6 million gain was recorded primarily related to land sales in the second quarter.

In the third quarter of fiscal 2013, we incurred $1.3 million related to severance and other benefits related to organizational changes made during the third quarter of fiscal 2013. The severance charges include expense related to the accelerated vesting of stock-based compensation awards.

During the first nine months of fiscal 2013, we recorded restaurant impairment charges of $0.7 million related to underperforming restaurants that either continue to operate or are scheduled to close. We also recorded $2.9 million in restaurant closure charges, consisting primarily of $1.7 million in lease termination charges and $0.9 million primarily related to the write-down of land associated with a closed facility. Additionally, we incurred $1.3 million in severance and other benefits and recorded net gains of $2.4 million primarily related to land sales.

Table of Contents

The impairment charges were measured as the excess of the carrying amount of property and equipment over the fair value. See Note 5 for fair value disclosures related to the restaurant impairment charges.

7. SHAREHOLDERS' EQUITY

In August 2013, our Board of Directors authorized a $200.0 million increase to our existing share repurchase program. We repurchased approximately 4.1 million shares of our common stock for $191.8 million during the first three quarters of fiscal 2014. As of March 26, 2014, approximately $354.7 million was available under our share repurchase authorizations. Our stock repurchase plan has been and will be used to return capital to shareholders and to minimize the dilutive impact of stock options and other share-based awards. We evaluate potential share repurchases under our plan based on several factors, including our cash position, share price, operational liquidity, proceeds from divestitures, and borrowing, planned investment and financing needs. Repurchased common stock is reflected as a reduction of shareholders' equity.

During the first three quarters of fiscal 2014, we granted approximately 175,000 stock options with a weighted average exercise price of $40.85 and a weighted average fair value of $15.65, and approximately 448,000 restricted share awards with a weighted average fair value of $39.61. Additionally, during the first three quarters of fiscal 2014, approximately 1.0 million stock options were exercised resulting in cash proceeds of approximately $24.6 million. We received an excess tax benefit from stock-based compensation of approximately $18.0 million during the first three quarters primarily as a result of the normally scheduled vesting and distribution of restricted stock grants and performance shares.

During the first three quarters of fiscal 2014, we paid dividends of $47.6 million to common stock shareholders, compared to $42.2 million in the prior year. Our Board of Directors approved a 20 percent increase in the quarterly dividend from $0.20 to $0.24 per share effective with the dividend declared in August 2013. Additionally, we declared a quarterly dividend of $15.8 million in February 2014 which was paid on March 27, 2014. The dividend accrual was included in accrued liabilities on our consolidated balance sheet as of March 26, 2014.

8. SUPPLEMENTAL CASH FLOW INFORMATION

Cash paid for income taxes and interest in the first three quarters of fiscal 2014 and 2013 are as follows (in thousands):

	March 26, 2014	March 27, 2013
Income taxes, net of refunds	$22,825	$38,799
Interest, net of amounts capitalized	14,640	15,909

Non-cash investing activities for the first three quarters of fiscal 2014 and 2013 are as follows (in thousands):

	March 26, 2014	March 27, 2013
Retirement of fully depreciated assets	$49,601	$43,262

9. CONTINGENCIES

In connection with the sale of restaurants to franchisees and brand divestitures, we have, in certain cases, guaranteed lease payments. As of March 26, 2014 and June 26, 2013, we have outstanding lease guarantees or are secondarily liable for $123.5 million and $132.6 million, respectively. These amounts represent the maximum potential liability of future payments under the guarantees. These leases have been assigned to the buyers and expire at the end of the respective lease terms, which range from fiscal 2014 through fiscal 2024. In the event of default, the indemnity and default clauses in our assignment agreements govern our ability to pursue and recover damages incurred. No material liabilities have been recorded as of March 26, 2014.

In August 2004, certain current and former hourly restaurant team members filed a putative class action lawsuit against us in California Superior Court alleging violations of California labor laws with respect to meal periods and rest breaks. The lawsuit sought penalties and attorney's fees and was certified as a class action by the trial court in July 2006. In July 2008, the California Court of Appeal decertified the class action on all claims with prejudice. In October 2008, the California Supreme Court granted a writ to review the decision of the Court of Appeal and oral arguments were heard by the California Supreme Court on November 8, 2011. On April 12, 2012, the California Supreme Court issued an opinion affirming in part, reversing in part, and remanding in part for further proceedings. The California Supreme Court's opinion resolved many of the legal standards for meal

Table of Contents

periods and rest breaks in our California restaurants. On September 26, 2013, the trial court granted plaintiffs' motion to certify a meal period subclass and denied our motion to decertify the rest period subclass. We intend to continue our vigorous defense of this lawsuit. Given the trial court's recent ruling, we believe it is reasonably possible that a loss has been incurred but the amount cannot be reasonably estimated at this time given there are significant issues to be resolved that will have a material impact on the potential loss or range of loss. Subsequent to the end of the quarter, the parties participated in a mediation where preliminary settlement discussions began, but a settlement was not achieved and significant issues still remain to be resolved that will have a material impact on the potential range of loss.

We are engaged in various other legal proceedings and have certain unresolved claims pending. Reserves have been established based on our best estimates of our potential liability in certain of these matters. We are of the opinion that, apart from the discussion above, there are no matters pending or threatened which are likely to have a material adverse effect, individually or in the aggregate, on our consolidated financial condition or results of operations. However, we understand that evaluating contingencies related to litigation is a complex process involving subjective judgment on the potential outcome of future events and the ultimate resolution of litigated claims may differ from our current analysis. Accordingly, we review the adequacy of accruals and disclosures pertaining to litigated matters each quarter in consultation with legal counsel and we assess the probability and range of possible losses associated with contingencies for potential accrual in the consolidated financial statements.

Table of Contents

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

The following table sets forth selected operating data as a percentage of total revenues (unless otherwise noted) for the periods indicated. All information is derived from the accompanying consolidated statements of comprehensive income:

	Thirteen Week Periods Ended				Thirty-Nine Week Periods Ended			
	March 26, 2014		March 27, 2013		March 26, 2014		March 27, 2013	
Revenues:								
Company sales	97.5	%	97.6	%	97.3	%	97.2	%
Franchise and other revenues	2.5	%	2.4	%	2.7	%	2.8	%
Total revenues	100.0	%	100.0	%	100.0	%	100.0	%
Operating costs and expenses:								
Company restaurants (excluding depreciation and amortization)								
Cost of sales [1]	26.5	%	27.4	%	26.9	%	27.6	%
Restaurant labor [1]	31.6	%	32.0	%	32.2	%	32.5	%
Restaurant expenses [1]	23.2	%	22.7	%	24.3	%	23.8	%
Company restaurant expenses [1]	81.3	%	82.1	%	83.4	%	83.9	%
Depreciation and amortization	4.5	%	4.5	%	4.7	%	4.7	%
General and administrative	4.5	%	4.6	%	4.6	%	4.8	%
Other gains and charges	0.3	%	0.2	%	0.2	%	0.1	%
Total operating costs and expenses	88.5	%	89.3	%	90.7	%	91.1	%
Operating income	11.5	%	10.7	%	9.3	%	8.9	%