

SONIC CORP
Form 10-Q
July 03, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 31, 2018

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 0-18859

SONIC CORP.
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization) 73-1371046
(I.R.S. Employer Identification No.)

300 Johnny Bench Drive
Oklahoma City, Oklahoma 73104
(Address of principal executive offices) (Zip Code)

(405) 225-5000
(Registrant's telephone number, including area code)

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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 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 No

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

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

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

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

As of June 27, 2018, approximately 36,085,715 shares of the registrant's common stock, par value \$0.01 per share, were outstanding.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SONIC CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts)

(Unaudited)

	May 31, 2018	August 31, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	\$44,869	\$22,340
Restricted cash	15,017	19,736
Accounts and notes receivable, net	37,571	33,758
Prepaid expenses and other current assets	6,678	13,350
Total current assets	104,135	89,184
Noncurrent restricted cash	13,457	42,120
Notes receivable, net	18,238	9,801
Property, equipment and capital leases	605,594	616,001
Less accumulated depreciation and amortization	(304,724)	(303,621)
Property, equipment and capital leases, net	300,870	312,380
Goodwill	75,344	75,756
Debt origination costs, net	1,299	2,439
Other assets, net	32,203	30,064
Total assets	\$545,546	\$561,744
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable	\$11,649	\$9,213
Franchisee deposits	530	1,093
Accrued liabilities	38,375	44,846
Income taxes payable	197	—
Current maturities of long-term debt and capital leases	7,761	3,464
Total current liabilities	58,512	58,616
Obligations under capital leases due after one year	13,632	16,167
Long-term debt, net	701,853	628,116
Deferred income taxes	25,737	40,101
Other non-current liabilities	19,072	20,502
Total non-current liabilities	760,294	704,886
Stockholders' deficit:		
Preferred stock, par value \$.01; 1,000 shares authorized; none outstanding	—	—
Common stock, par value \$.01; 245,000 shares authorized; 118,309 shares issued (118,309 shares issued at August 31, 2017)	1,183	1,183
Paid-in capital	236,380	236,895
Retained earnings	968,405	934,017
Treasury stock, at cost; 82,120 shares (78,081 shares at August 31, 2017)	(1,479,228)	(1,373,853)
Total stockholders' deficit	(273,260)	(201,758)
Total liabilities and stockholders' deficit	\$545,546	\$561,744

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

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SONIC CORP.
 CONDENSED CONSOLIDATED STATEMENTS OF INCOME
 (In thousands, except per share amounts)
 (Unaudited)

	Three months ended May 31,		Nine months ended May 31,	
	2018	2017	2018	2017
Revenues:				
Company Drive-In sales	\$66,587	\$72,062	\$182,217	\$223,500
Franchise Drive-Ins:				
Franchise royalties and fees	48,251	48,220	122,766	122,687
Lease revenue	2,203	2,418	5,288	5,474
Other	1,265	1,290	1,565	2,038
Total revenues	118,306	123,990	311,836	353,699
Costs and expenses:				
Company Drive-Ins:				
Food and packaging	18,549	19,380	50,863	61,112
Payroll and other employee benefits	23,468	25,590	67,325	82,688
Other operating expenses, exclusive of depreciation and amortization included below	12,354	13,836	37,303	47,540
Total cost of Company Drive-In sales	54,371	58,806	155,491	191,340
Selling, general and administrative	21,118	20,763	57,733	58,813
Depreciation and amortization	9,566	9,520	28,492	29,531
Other operating income, net	(4,010)	(540)	(4,503)	(11,105)
Total costs and expenses	81,045	88,549	237,213	268,579
Income from operations	37,261	35,441	74,623	85,120
Interest expense	8,598	7,318	24,411	21,734
Interest income	(524)	(291)	(1,361)	(1,047)
Loss from debt transactions	—	—	1,310	—
Net interest expense	8,074	7,027	24,360	20,687
Income before income taxes	29,187	28,414	50,263	64,433
Provision for income taxes	7,611	9,663	(2,350)	21,601
Net income	\$21,576	\$18,751	\$52,613	\$42,832
Basic income per share	\$0.58	\$0.44	\$1.38	\$0.97
Diluted income per share	\$0.58	\$0.44	\$1.36	\$0.96
Cash dividends declared per common share	\$0.16	\$0.14	\$0.48	\$0.42

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

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SONIC CORP.
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
 (In thousands)
 (Unaudited)

	Nine months ended May 31,	
	2018	2017
Cash flows from operating activities:		
Net income	\$52,613	\$42,832
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	28,492	29,531
Stock-based compensation expense	3,318	2,906
Loss from debt transactions	1,310	—
Benefit from deferred income taxes	(14,279)	(1,354)
Gain on disposition of assets, net	(4,989)	(12,097)
Other	1,821	1,388
Change in operating assets and liabilities:		
(Increase) decrease in restricted cash	5,088	4,549
(Increase) decrease in accounts receivable and other assets	(5,749)	(2,124)
Increase (decrease) in accounts payable	(705)	(2,894)
Increase (decrease) in accrued and other liabilities	(3,998)	(12,701)
Increase (decrease) in income taxes	1,910	44
Total adjustments	12,219	7,248
Net cash provided by operating activities	64,832	50,080
Cash flows from investing activities:		
Purchases of property and equipment	(24,523)	(37,146)
Proceeds from sale of assets	16,278	62,393
Proceeds from sale of investment in refranchised drive-in operations	—	8,354
Issuance of notes receivable	(14,158)	(1,214)
Collections on notes receivable	6,232	10,114
Other	659	1,674
Net cash provided by (used in) investing activities	(15,512)	44,175
Cash flows from financing activities:		
Purchases of treasury stock	(110,621)	(128,180)
Payment of dividends	(18,184)	(18,485)
Payments on debt	(171,000)	(10,417)
Proceeds from borrowings	253,000	43,000
Restricted cash for securitization obligations	28,294	203
Debt issuance costs and prepayment premiums	(5,121)	(10)
Proceeds from exercise of stock options	1,635	2,528
Other	(4,794)	(2,936)
Net cash used in financing activities	(26,791)	(114,297)
Net increase (decrease) in cash and cash equivalents	22,529	(20,042)
Cash and cash equivalents at beginning of period	22,340	72,092
Cash and cash equivalents at end of period	\$44,869	\$52,050

Supplemental cash flow information

Cash paid during the period for:

Interest	\$22,626	\$20,210
Income taxes (net of refunds)	10,175	22,985
Non-cash investing and financing activities:		
Net additions to capital lease obligations	\$97	\$1,433
Change in obligation to acquire treasury stock	(1,521)	(516)
Stock options exercised by swap	2,697	—

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

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with United States (“U.S.”) generally accepted accounting principles (“GAAP”) and with the rules and regulations of the Securities and Exchange Commission (“SEC”). Accordingly, they do not include all of the information and notes required by GAAP for complete financial statements of Sonic Corp. (the “Company”). In the opinion of management, these financial statements reflect all adjustments of a normal recurring nature, including recurring accruals, necessary for the fair presentation of the Company’s financial position, results of operations and cash flows for the interim periods presented in conformity with GAAP. In certain situations, recurring accruals, including franchise royalties, are based on more limited information at interim reporting dates than at the Company’s fiscal year end due to the abbreviated reporting period. Actual results may differ from these estimates. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended August 31, 2017, included in the Company’s Annual Report on Form 10-K. Interim results are not necessarily indicative of the results that may be expected for a full year or any other interim period.

Principles of Consolidation

The accompanying financial statements include the accounts of the Company, its wholly owned subsidiaries and a number of Company Drive-Ins in which a subsidiary has a controlling ownership interest. All intercompany accounts and transactions have been eliminated.

New Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers,” which requires an entity to recognize revenue in an amount that reflects the consideration to which the entity expects to be entitled for the transfer of promised goods or services to customers. The standard also requires additional disclosure regarding the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The ASU will replace most of the existing revenue recognition requirements in U.S. GAAP when it becomes effective. Further, the FASB has issued clarifying guidance with ASU No. 2016-08, “Revenue from Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net),” ASU No. 2016-10, “Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing,” and ASU No. 2016-20, “Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers.” ASU No. 2016-08 provides guidance for evaluating when another party, along with the entity, is involved in providing a good or service to a customer. ASU No. 2016-10 clarifies assessing whether promises to transfer goods or services are distinct, and whether an entity's promise to grant a license provides a customer with a right to use or right to access the entity's intellectual property. ASU No. 2016-20 provides corrections or improvements to issues that affect narrow aspects of the guidance.

The Company plans to adopt the standards in the first quarter of fiscal year 2019 using the cumulative effect transition method. The Company does not believe the new revenue recognition standard will impact the recognition of sales from Company Drive-Ins or the recognition of royalty fees from franchisees, nor will it have a material impact to the recognition of gift card breakage. The Company expects the pronouncement will impact the recognition of the initial franchise fee, which is currently recognized upon the opening of a Franchise Drive-In. The impact on these fees is not expected to be material to total revenue. The Company is finalizing the impact of the required cumulative effect adjustment to be recorded to the balance sheet on the date of initial application and continues to evaluate the effect

this pronouncement will have on principal versus agent considerations, other transactions, the financial statements and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, "Leases." The new standard, which replaces existing lease guidance, requires lessees to recognize on the balance sheet a liability to make lease payments and a corresponding right-of-use asset. The guidance also requires certain qualitative and quantitative disclosures designed to assess the amount, timing and uncertainty of cash flows arising from leases. Accounting guidance for lessors is largely unchanged. In January 2018, the FASB issued ASU No. 2018-01. ASU 2018-01 permits an entity to elect an optional transition practical expedient to forgo the evaluation of land easements that existed or expired before the entity's adoption of 2016-02 and that were not accounted for as leases under previous lease guidance. The standard is effective for fiscal year 2020, with early application permitted. This standard requires adoption based upon a modified retrospective transition approach for leases existing at, or entered into after,

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

the beginning of the earliest comparative period presented in the financial statements, with optional practical expedients. Based on a preliminary assessment, the Company expects that most of its operating lease commitments will be subject to the new guidance and recognized as operating lease liabilities and right-of-use assets upon adoption, resulting in a significant increase in the assets and liabilities on the consolidated balance sheet. The Company is continuing its assessment, which may identify additional impacts this standard will have on its consolidated financial statements and related disclosures.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments - Credit Losses." The update was issued to provide more decision-useful information about the expected credit losses on financial instruments. The update replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The update is effective for fiscal year 2021, with early adoption permitted for fiscal years beginning after December 15, 2018. The update should be adopted using a modified-retrospective approach. The Company is currently evaluating the effect this update will have on its financial statements and related disclosures.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows - Classification of Certain Cash Receipts and Cash Payments." The update is intended to reduce diversity in practice in how certain transactions are classified and will make eight targeted changes to how cash receipts and cash payments are presented in the statement of cash flows. The update is effective for fiscal year 2019. The new standard will require adoption on a retrospective basis unless it is impracticable to apply, in which case the amendments will apply prospectively as of the earliest date practicable. The Company is currently evaluating the effect of this update but does not believe it will have a material impact on its financial statements and related disclosures.

In October 2016, the FASB issued ASU No. 2016-16, "Income Taxes: Intra-Entity Transfers of Assets Other Than Inventory," as part of its simplification initiatives. The update requires that an entity recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs, rather than deferring the recognition until the asset has been sold to an outside party as is required under current GAAP. The update is effective for fiscal year 2019. The new standard will require adoption on a modified retrospective basis through a cumulative-effect adjustment to retained earnings, and early adoption is permitted. The Company is currently evaluating the effect of this update but does not believe it will have a material impact on its financial statements and related disclosures.

In November 2016, the FASB issued ASU No. 2016-18, "Statement of Cash Flows - Restricted Cash." The update requires that restricted cash balances be included in the beginning and ending cash balance within the statement of cash flows. The update is effective for fiscal year 2019. The amendments should be adopted on a retrospective basis for each period presented, and early adoption is permitted. The adoption will increase the beginning and ending cash balance within the Company's statement of cash flows by its restricted cash balances and will require a new disclosure to reconcile the cash balances within the statement of cash flows to the balance sheets. The Company does not expect any other material impacts to its financial statements.

In May 2017, the FASB issued ASU No. 2017-09, "Compensation - Stock Compensation: Scope of Modification Accounting," which provides guidance about which changes to the terms or conditions of a share-based payment award require an entity to apply modification accounting. An entity will account for the effects of a modification unless the fair value of the modified award is the same as the original award, the vesting conditions of the modified award are the same as the original award and the classification of the modified award as an equity instrument or liability instrument is the same as the original award. The update is effective for fiscal year 2019. The update is to be adopted prospectively to an award modified on or after the adoption date. Early adoption is permitted. The Company is currently evaluating the effect of this update but does not believe it will have a material impact on its financial statements and related disclosures.

The Company has reviewed all other recently issued accounting pronouncements and concluded they are not applicable or not expected to be significant to our operations.

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

2. Earnings Per Share

The following table sets forth the computation of basic and diluted earnings per share:

	Three months ended May 31, 2018		Nine months ended May 31, 2017	
Numerator:				
Net income	\$21,576	\$18,751	\$52,613	\$42,832
Denominator:				
Weighted average common shares outstanding– basic	36,924	42,402	38,178	43,972
Effect of dilutive employee stock options and unvested restricted stock units	392	691	455	757
Weighted average common shares outstanding – diluted	37,316	43,093	38,633	44,729
Net income per common share – basic	\$0.58	\$0.44	\$1.38	\$0.97
Net income per common share – diluted	\$0.58	\$0.44	\$1.36	\$0.96
Anti-dilutive securities excluded ⁽¹⁾	1,898	1,362	1,534	1,095

(1) Anti-dilutive securities consist of stock options and unvested restricted stock units that were not included in the computation of diluted earnings per share because either the exercise price of the options was greater than the average market price of the common stock or the total assumed proceeds under the treasury stock method resulted in negative incremental shares and thus the inclusion would have been anti-dilutive.

3. Share Repurchase Program

During fiscal year 2017, approximately 6.7 million shares were repurchased under the Company's share repurchase program for a total cost of \$172.9 million, resulting in an average price per share of \$25.71. In August 2017, the Board of Directors approved an incremental \$160.0 million share repurchase authorization of the Company's outstanding shares of common stock through August 31, 2018.

During the first nine months of fiscal year 2018, approximately 4.3 million shares were repurchased for a total cost of \$109.1 million, resulting in an average price per share of \$25.23. The total remaining authorized under the share repurchase program as of May 31, 2018 was \$50.9 million.

Subsequent to the end of the quarter, the Board of Directors authorized a \$500.0 million share repurchase program through August 31, 2021, replacing the Company's previous fiscal year 2018 authorization. Including amounts purchased during the first nine months of the fiscal year, the total remaining authorized under the share repurchase program is \$390.9 million.

Share repurchases may be made from time to time in the open market or otherwise, including through an accelerated share repurchase program, under terms of a Rule 10b5-1 plan, in privately negotiated transactions or in round lot or block transactions. The share repurchase program may be extended, modified, suspended or discontinued at any time.

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

4. Income Taxes

The following table presents the Company's provision for income taxes and effective income tax rate for the periods below:

	Three months ended May 31,		Nine months ended May 31,	
	2018	2017	2018	2017
Provision for income taxes	\$7,611	\$9,663	\$(2,350)	\$21,601
Effective income tax rate	26.1 %	34.0 %	(4.7)%	33.5 %

The lower effective income tax rate during the third quarter and first nine months of fiscal year 2018 was due primarily to the recognition of the impacts of the Tax Cuts and Jobs Act ("TCJA") discussed below.

On December 22, 2017, the TCJA was signed into law, significantly impacting several sections of the Internal Revenue Code. The most significant impacts on the Company for fiscal year 2018 include:

Effective January 1, 2018, the U.S. corporate federal statutory income tax rate was reduced from 35% to 21%. Because of our fiscal year end, the Company's statutory federal tax rate is 25.7% for fiscal year 2018 and 21% for fiscal year 2019 and thereafter.

The Company remeasured its existing deferred tax assets and liabilities at the rate the Company expects to be in effect when those deferred taxes will be realized (either 25.7% if in 2018 or 21% thereafter). The Company recognized a discrete benefit from the deferred tax remeasurement of approximately \$14.1 million in the second quarter of fiscal year 2018.

In December 2017, the SEC provided guidance allowing registrants to record provisional amounts, during a specified measurement period, when the necessary information is not available, prepared or analyzed in reasonable detail to account for the impact of the TCJA. Accordingly, we have reported the revaluation of our deferred tax assets and liabilities based on provisional amounts. In the three months ended May 31, 2018, no material changes to the provisional amounts occurred.

Among the factors that could affect the accuracy of our provisional amounts is uncertainty about the statutory tax rate applicable to our deferred income tax assets and liabilities, since the actual rate will be dependent on the timing of realization or settlement of such assets and liabilities. At May 31, 2018, we estimated the dates when such realization or settlement would occur. The actual dates when such realization or settlement occurs may be significantly different from our estimates, which could result in the ultimate revaluation of our deferred income taxes to be different from our provisional amounts. In addition, there is uncertainty about the impact of expected Internal Revenue Service guidance intended to interpret the most complex provisions of the TCJA.

We are currently assessing the potential additional impact of the TCJA on our consolidated financial statements and expect to complete such assessment on or before August 31, 2018.

The difference between our U.S. federal statutory income tax rate and our effective income tax rate for the nine months ended May 31, 2018 and 2017 is summarized below:

Nine	Nine
months	months

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	ended	ended
	May 31,	May
	2018	31,
		2017
U.S. federal statutory income tax rate	25.7 %	35.0 %
State income taxes, net of federal tax benefit	3.4 %	2.6 %
Federal tax benefit of statutory tax deduction	(1.3)%	(1.4)%
Employment related and other tax credits, net	(1.5)%	(1.7)%
Stock option excess tax benefit	(2.8)%	(1.4)%
Deferred tax revaluation	(28.1)%	— %
Other	(0.1)%	0.4 %
Effective tax rate	(4.7)%	33.5 %

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

5. Accounts and Notes Receivable

Accounts and notes receivable consist of the following:

	May 31, 2018	August 31, 2017
Current accounts and notes receivable:		
Royalties and other trade receivables	\$21,046	\$ 19,571
Notes receivable from franchisees	1,311	1,441
Receivables from system funds	6,540	6,360
Other	9,775	7,475
Accounts and notes receivable, gross	38,672	34,847
Allowance for doubtful accounts and notes receivable	(1,101)	(1,089)
Current accounts and notes receivable, net	\$37,571	\$ 33,758
Noncurrent notes receivable:		
Receivables from franchisees	\$8,562	\$ 6,810
Receivables from system funds	10,113	3,033
Allowance for doubtful notes receivable	(437)	(42)
Noncurrent notes receivable, net	\$18,238	\$ 9,801

The Company's receivables are primarily due from franchisees, all of whom are in the restaurant business. Substantially all of the notes receivable from franchisees are collateralized by real estate or equipment. The receivables from system funds represent transactions in the normal course of business.

6. Contingencies

Litigation

As reported in the Annual Report on Form 10-K for the year ended August 31, 2017, the Company was named as a defendant in five purported class action complaints related to a payment card breach at certain Sonic Drive-Ins. The Company has since been named as a defendant in four additional purported class action complaints filed on October 9, 2017, in the United States District Court for the Northern District of Ohio, on November 3, 2017, in the United States District Court for the Northern District of Texas, on November 13, 2017, in the United States District Court for the District of Arizona, and on December 17, 2017, in the Northern District of Illinois. Each of these complaints asserted various claims related to the Company's alleged failure to safeguard customer credit card information, and the plaintiffs sought monetary damages, injunctive and declaratory relief and attorneys' fees and costs. The cases were centralized in the Northern District of Ohio for coordinated or consolidated pretrial proceedings, and a consolidated complaint was filed. The Company believes it has meritorious defenses to the litigation and intends to vigorously oppose the claims asserted in the complaint. We cannot reasonably estimate the range of potential losses that may be associated with the litigation because of the early stage of the lawsuit. We also cannot provide assurance we will not become subject to other inquiries or claims relating to the payment card breach in the future. Although we maintain cyber liability insurance, we currently believe it is possible the ultimate amount paid by us, if we are unsuccessful in defending the litigation, will be in excess of our cyber liability insurance coverage applicable to claims of this nature. We are unable to estimate the amount of any such excess.

The Company is involved in various other legal proceedings and has certain unresolved claims pending. Based on the information currently available, management believes all such other claims currently pending are either covered by insurance or would not have a material adverse effect on the Company's business or financial condition.

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SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share data)

(Unaudited)

Note Repurchase Agreement

On December 20, 2013, the Company extended a note purchase agreement to a bank that serves to guarantee the repayment of a franchisee loan, with a term through 2018. In the event of default by the franchisee, the Company would purchase the franchisee loan from the bank, thereby becoming the note holder and providing an avenue of recourse with the franchisee. The Company recorded a liability for this guarantee which was based on the Company's estimate of fair value. As of May 31, 2018, the balance of the franchisee's loan was \$5.2 million.

Lease Commitments

The Company has obligations under various operating lease agreements with third-party lessors related to the real estate for certain Company Drive-In operations that were sold to franchisees. Under these agreements, which expire through 2029, the Company remains secondarily liable for the lease payments for which it was responsible as the original lessee. As of May 31, 2018, the amount remaining under these guaranteed lease obligations totaled \$15.4 million. At this time, the Company does not anticipate any material defaults under the foregoing leases; therefore, zero liability has been provided.

7. Fair Value of Financial Instruments

The fair value of financial instruments is the amount at which the instrument could be exchanged in a current transaction between willing parties. The Company has no financial liabilities that are required to be measured at fair value on a recurring basis.

The Company categorizes its assets and liabilities recorded at fair value based on the following fair value hierarchy established by the FASB:

Level 1 valuations use quoted prices in active markets for identical assets or liabilities that are accessible at the measurement date. An active market is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2 valuations use inputs other than actively quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs include: (a) quoted prices for similar assets or liabilities in active markets, (b) quoted prices for identical or similar assets or liabilities in markets that are not active, (c) inputs other than quoted prices that are observable for the asset or liability, such as interest rates and yield curves observable at commonly quoted intervals and (d) inputs that are derived principally from or corroborated by observable market data by correlation or other means.

Level 3 valuations use unobservable inputs for the asset or liability. Unobservable inputs are used to the extent observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

The Company's cash equivalents, some of which are included in restricted cash, are carried at cost which approximates fair value and totaled \$63.8 million at May 31, 2018 and \$73.9 million at August 31, 2017. This fair value is estimated using Level 1 inputs.

At May 31, 2018, the fair value of the Company's Series 2018-1 Senior Secured Fixed Rate Notes, Class A-2 (the "2018 Fixed Rate Notes"), the Series 2016-1 Senior Secured Fixed Rate Notes, Class A-2 (the "2016 Fixed Rate Notes") and the Series 2013-1 Senior Secured Fixed Rate Notes, Class A-2 (the "2013 Fixed Rate Notes" and together with the 2018

Fixed Rate Notes and 2016 Fixed Rate Notes, the “Fixed Rate Notes”) approximated the carrying value, including accrued interest, of \$720.4 million. At August 31, 2017, the fair value of the Company's 2016 Fixed Rate Notes and 2013 Fixed Rate Notes approximated the carrying value, including accrued interest, of \$578.2 million. At May 31, 2018, there was no balance on the Company's Series 2016-1 Senior Secured Variable Funding Notes, Class A-1 (the “2016 Variable Funding Notes” and, together with the Fixed Rate Notes, the “Notes”). At August 31, 2017 the fair value of the 2016 Variable Funding Notes approximated the carrying value of \$60.1 million, including accrued interest. The fair value of the Notes is estimated using Level 2 inputs from market information available for public debt transactions for companies with ratings that are similar to the Company’s ratings and from information gathered from brokers who trade in the Company’s notes.

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(In thousands, except per share data)

(Unaudited)

8. Debt

During the second quarter of fiscal year 2018, the Company made a pro rata prepayment of \$28.0 million on its 2013 Fixed Rate Notes and 2016 Fixed Rate Notes. The prepayment was made at par, as allowed under the note terms.

On February 1, 2018, various subsidiaries of the Company (the “Co-Issuers”) issued \$170.0 million of 2018 Fixed Rate Notes in a private transaction which bears interest at 4.03% per annum. The 2018 Fixed Rate Notes have an expected life of seven years with an anticipated repayment date in February 2025. At May 31, 2018, the balance outstanding under the 2018 Fixed Rate Notes including accrued interest totaled \$170.2 million and carried a weighted-average interest cost of 4.40%, including the effect of the loan origination costs described below.

Sonic used a portion of the net proceeds from the issuance of the 2018 Fixed Rate Notes to pay down the outstanding portion of the 2016 Variable Funding Notes and to pay the costs associated with the securitized financing transaction. In conjunction with the issuance of the 2018 Fixed Rate Notes, the commitments under the 2016 Variable Funding Notes were reduced to \$100.0 million.

Loan origination costs associated with the Company’s 2018 Fixed Rate Notes totaled \$5.0 million. Loan costs are amortized over each note’s expected life, and the unamortized balance related to the 2016 Variable Funding Notes and the Fixed Rate Notes is included in debt origination costs, net and long-term debt, net, respectively, on the condensed consolidated balance sheets.

In connection with the 2018 transactions described above, the Company recognized a \$1.3 million loss during the second quarter of fiscal year 2018. The loss consisted of a \$0.7 million write-off of unamortized deferred debt origination costs related to the reduction of the 2016 Variable Funding Notes commitments, as well as a \$0.4 million write-off of unamortized deferred debt origination costs related to the prepayment on its 2013 Fixed Rate Notes and 2016 Fixed Rate Notes. Additionally, as required by the terms of the 2016 Fixed Rate Notes, the Company paid a \$0.2 million prepayment premium.

While the 2018 Fixed Rate Notes have an expected life of seven years, they have a legal final maturity date of February 2048. The Company intends to repay or refinance the 2018 Fixed Rate Notes on or before the end of their respective expected life. In the event the 2018 Fixed Rate Notes are not paid in full by the end of their expected life, the Notes are subject to an upward adjustment in the annual interest rate of at least 5%. In addition, principal payments will accelerate by applying all of the royalties, lease revenues and other fees securing the debt, after deducting certain expenses, until the debt is paid in full. Also, any unfunded amount under the 2016 Variable Funding Notes will become unavailable.

The Co-Issuers and Sonic Franchising LLC (the “Guarantor”) are existing special purpose, bankruptcy remote, indirect subsidiaries of Sonic Corp. that hold substantially all of Sonic’s franchising assets and real estate. As of May 31, 2018, assets for these combined indirect subsidiaries totaled \$255.2 million, including receivables for royalties, certain Company and Franchise Drive-In real estate, intangible assets and restricted cash balances of \$28.5 million. The Notes are secured by franchise fees, royalty payments and lease payments, and the repayment of the Notes is expected to be made solely from the income derived from the Co-Issuer’s assets. In addition, the Guarantor, a Sonic Corp. subsidiary that acts as a franchisor, has guaranteed the obligations of the Co-Issuers under the Notes and pledged substantially all of its assets to secure those obligations.

Neither Sonic Corp., the ultimate parent of the Co-Issuers and the Guarantor, nor any other subsidiary of Sonic, guarantees or in any way is liable for the obligations of the Co-Issuers under the 2018 Fixed Rate Notes. The Company has, however, agreed to cause the performance of certain obligations of its subsidiaries, principally related to managing the assets included as collateral for the 2018 Fixed Rate Notes and certain indemnity obligations relating to the transfer of the collateral assets to the Co-Issuers.

The 2018 Fixed Rate Notes are subject to a series of covenants and restrictions similar to the Company's 2016 Fixed Rate Notes and customary for transactions of this type. If certain covenants or restrictions are not met, the Notes are subject to customary accelerated repayment events and events of default. Although management does not anticipate an event of default or

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(In thousands, except per share data)

(Unaudited)

any other event of noncompliance with the provisions of the debt, if such event occurred, the unpaid amounts outstanding could become immediately due and payable.

9. Other Operating Income

During the first quarter of fiscal year 2017, the Company recorded a gain of \$3.8 million on the sale of minority investments in franchise operations retained as part of a refranchising transaction that occurred in fiscal year 2009. The gain is reflected in other operating income, net, on the condensed consolidated statement of income.

10. Refranchising

During the third quarter of fiscal year 2018, the Company recognized a net gain of \$3.2 million related to the refranchised operations of 41 drive-ins and retained a non-controlling minority investment in the franchise operations. These transactions represent additional markets identified after completion of the refranchising initiative in fiscal year 2017 and bring the Company to a 95% franchised system.

The Company completed a previously announced refranchising initiative in fiscal year 2017. During the first six months of fiscal year 2017, 110 Company Drive-Ins were refranchised, and the Company retained a non-controlling minority investment in most of the franchise operations.

The gains and losses related to refranchised drive-ins are recorded in other operating income, net, on the condensed consolidated statement of income. Income from minority investments is included in other revenue on the condensed consolidated statements of income.

In addition to the refranchised drive-ins discussed above in which the Company retained a non-controlling minority investment in the operations, the Company also refranchised the operations of two drive-ins during the third quarter and eight drive-ins during the first nine months of fiscal year 2018, respectively, compared to five drive-ins refranchised during the third quarter and first nine months of fiscal year 2017. These refranchising transactions all occurred in the normal course of business and did not result in any retained interests.

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(In thousands, except per share data)

(Unaudited)

The following is a summary of the pretax activity recorded as a result of the refranchising initiative transactions in fiscal year 2017 (in thousands, except number of refranchised Company Drive-Ins):

	Three months ended May 31, 2017	Nine months ended May 31, 2017
Number of refranchised Company Drive-Ins	—	110
Proceeds from sales of Company Drive-Ins	\$ —	\$20,036
Proceeds from sale of real estate ⁽¹⁾	4,749	4,749
Proceeds receivable from sale of real estate ⁽¹⁾	6,977	6,977
Real estate assets sold ⁽¹⁾	(12,095)	(12,095)
Assets sold, net of retained minority investment ⁽²⁾	847	(7,891)
Initial and subsequent lease payments for real estate option ⁽¹⁾	195	(3,201)
Goodwill related to sales of Company Drive-Ins	—	(966)
Deferred gain for real estate option ⁽³⁾	141	(899)
Gain (loss) on assets held for sale	—	(65)
Refranchising initiative gains, net	\$ 814	\$6,645

During the first quarter of fiscal year 2017, as part of a 53 drive-in refranchising transaction, a portion of the proceeds was applied as the initial payment for an option to purchase the real estate within the next 24 months. The (1) franchisee initiated exercise of the option during the third fiscal quarter and a portion of the proceeds was received after the quarter ended. Until the option was fully exercised, the franchisee made monthly lease payments which were included in other operating income, net of sub-lease expense.

(2) Net assets sold consisted primarily of equipment. During the third quarter of fiscal year 2017, the Company made an adjustment to retained minority investment.

The deferred gain of \$0.9 million is recorded in other non-current liabilities as a result of a real estate purchase (3) option extended to the franchisee in the second quarter of fiscal year 2017. The deferred gain will continue to be amortized into income through January 2020 when the option becomes exercisable.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

In the Quarterly Report on Form 10-Q, unless the context otherwise requires, the terms "Sonic Corp.," "the Company," "we," "us" and "our" refer to Sonic Corp. and its subsidiaries.

Overview

System same-store sales decreased 0.2% during the third quarter and 1.5% for the first nine months of fiscal year 2018 as compared to a decrease of 1.2% and 3.3%, respectively, for the same periods last year. Same-store sales at Company Drive-Ins increased 0.2% during the third quarter and decreased 2.1% for the first nine months of fiscal year 2018 as compared to a decrease of 3.2% and 4.7%, respectively, for the same periods last year. The same-store sales decreases reflect a decline in traffic, which was impacted by adverse weather and aggressive competitive activity in the first half of the fiscal year, partially offset by positive momentum from Company initiatives seen during the third fiscal quarter. We continue to execute on our long-term strategies, including new technology, product innovation, personalized service, brand-appropriate value promotions and our fully integrated media strategy. All of these initiatives fuel Sonic's strategy to drive growth through improvement in same-store sales and new drive-in development, and to enhance returns through the deployment of cash to shareholders. Same-store sales growth is the most important component to driving brand value as it generates operating leverage, increased operating cash flows and improved return on investment.

Revenues decreased to \$118.3 million for the third quarter and \$311.8 million for the first nine months of fiscal year 2018 from \$124.0 million and \$353.7 million, respectively, for the same periods last year, due to a decrease in Company Drive-In sales. The decrease in Company Drive-In sales was a result of refranchising certain Company Drive-Ins during fiscal year 2017 as part of our initiative to move toward an approximately 95%-franchised system. To a lesser degree, the decline in revenues is also attributed to decreased same-store sales. Restaurant margins at Company Drive-Ins were unfavorable by 10 basis points during the third quarter and favorable by 30 basis points for the first nine months of fiscal year 2018 as compared to the same periods last year, reflecting the impact of refranchising underperforming drive-ins, commodity cost inflation and the de-leveraging impact of same-stores sales decreases.

Third quarter results for fiscal year 2018 reflected net income of \$21.6 million or \$0.58 per diluted share as compared to net income of \$18.8 million or \$0.44 per diluted share for the same period last year. Net income and diluted earnings per share for the first nine months of fiscal year 2018 were \$52.6 million and \$1.36, respectively, as compared to net income of \$42.8 million and diluted earnings per share of \$0.96 for the same period last year. Adjustments to net income are detailed below in Results of Operations.

In December 2017, Congress enacted comprehensive amendments to the Internal Revenue Code of 1986 with the passage of the Tax Cuts and Jobs Act ("TCJA"). Based on the amendments, our U.S. federal statutory tax rate decreased to 25.7% for fiscal year 2018, and we recorded a discrete net provisional benefit of approximately \$14.1 million for the revaluation of deferred tax assets and liabilities in the second quarter of fiscal year 2018.

During the third quarter of fiscal year 2018, we recognized a net gain of \$3.2 million related to the refranchised operations of 41 drive-ins and retained a non-controlling minority investment in the franchise operations. These transactions represent additional markets identified after completion of the refranchising initiative in fiscal year 2017 and bring the Company to a 95% franchised system.

We completed a previously announced refranchising initiative in fiscal year 2017. During the first six months of fiscal year 2017, 110 Company Drive-Ins were refranchised, and we retained a non-controlling minority investment in most of the franchise operations. The Company recorded a gain of \$6.6 million on these transactions.

In addition to the refranchised drive-ins discussed above in which we retained a non-controlling minority investment in the operations, we also refranchised the operations of two drive-ins during the third quarter and eight drive-ins during the first nine months of fiscal year 2018, respectively, compared to five drive-ins refranchised during the third quarter and first nine months of fiscal year 2017. These refranchising transactions all occurred in the normal course of business and did not result in any retained interests.

The gains and losses related to refranchised drive-ins are recorded in other operating income, net, on the condensed consolidated statement of income. Income from minority investments is included in other revenue on the condensed consolidated statements of income. For additional information on transactions associated with the refranchising initiative, see Note 10 - Refranchising, included in Part I, Item 1, "Financial Statements," in this Quarterly Report on Form 10-Q for more information.

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The following table provides information regarding the number of Company Drive-Ins and Franchise Drive-Ins operating as of the end of the periods indicated as well as the system change in sales and average unit volume. System information includes both Company Drive-In and Franchise Drive-In information, which we believe is useful in analyzing the growth of the brand as well as the Company's revenues since franchisees pay royalties based on a percentage of sales.

System Performance
(\$ in thousands)

	Three months ended May 31, 2018		Nine months ended May 31, 2018	
	2017		2017	
Increase (decrease) in total sales	1.1 %	(0.5)%	(0.1)%	(2.5)%
System drive-ins in operation ⁽¹⁾ :				
Total at beginning of period	3,587	3,562	3,593	3,557
Opened	5	15	18	39
Closed (net of re-openings)	(3)	(6)	(22)	(25)
Total at end of period	3,589	3,571	3,589	3,571
Average sales per drive-in	\$347	\$346	\$901	\$907
Change in same-store sales ⁽²⁾	(0.2)%	(1.2)%	(1.5)%	(3.3)%

(1) Drive-ins that are temporarily closed for various reasons (repairs, remodeling, relocations, etc.) are not considered closed unless the Company determines they are unlikely to reopen within a reasonable time.

(2) Represents percentage change for drive-ins open for a minimum of 15 months.

Results of Operations

Revenues. The following table sets forth the components of revenue for the reported periods and the relative change between the comparable periods.

Revenues
(\$ in thousands)

	Three months ended May 31, 2018		Increase (Decrease)	Percent Increase (Decrease)
	2017			
Company Drive-In sales	\$66,587	\$72,062	\$ (5,475)	(7.6)%
Franchise Drive-Ins:				
Franchise royalties	48,063	47,890	173	0.4 %
Franchise fees	188	330	(142)	(43.0)%
Lease revenue	2,203	2,418	(215)	(8.9)%

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Other	1,265	1,290	(25)	(1.9)%
Total revenues	\$118,306	\$123,990	\$ (5,684)	(4.6)%

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	Nine months ended May 31,		Increase (Decrease)	Percent Increase (Decrease)	
	2018	2017			
Company Drive-In sales	\$182,217	\$223,500	\$(41,283)	(18.5)%	
Franchise Drive-Ins:					
Franchise royalties	122,285	121,910	375	0.3	%
Franchise fees	481	777	(296)	(38.1)%	
Lease revenue	5,288	5,474	(186)	(3.4)%	
Other	1,565	2,038	(473)	(23.2)%	
Total revenues	\$311,836	\$353,699	\$(41,863)	(11.8)%	

The following table reflects the changes in sales and same-store sales at Company Drive-Ins. It also presents information about average unit volumes and the number of Company Drive-Ins, which is useful in analyzing the change in Company Drive-In sales.

Company Drive-In Sales

(\$ in thousands)

	Three months ended May 31,		Nine months ended May 31,	
	2018	2017	2018	2017
Company Drive-In sales	\$66,587	\$72,062	\$182,217	\$223,500
Percentage decrease	(7.6)%	(37.4)%	(18.5)%	(28.9)%
Company Drive-Ins in operation ⁽¹⁾ :				
Total at beginning of period	222	233	228	345
Opened	—	2	—	3
Sold to franchisees	(43)	(5)	(49)	(115)
Closed (net of re-openings)	—	—	—	(3)
Total at end of period	179	230	179	230
Average sales per Company Drive-In	\$318	\$312	\$826	\$818
Change in same-store sales ⁽²⁾	0.2	% (3.2)%	(2.1)%	(4.7)%

⁽¹⁾ Drive-ins that are temporarily closed for various reasons (repairs, remodeling, relocations, etc.) are not considered closed unless the Company determines they are unlikely to reopen within a reasonable time.

⁽²⁾ Represents percentage change for drive-ins open for a minimum of 15 months.

Same-store sales for Company Drive-Ins increased 0.2% for the third quarter and decreased 2.1% for the first nine months of fiscal year 2018, as compared to a decrease of 3.2% and 4.7% for the same periods last year, reflecting adverse weather as well as aggressive competitive activity in the first half of the fiscal year, partially offset by positive momentum from Company initiatives in the third fiscal quarter. We continue to focus on our innovative product pipeline, multi-day-part promotions and increased media effectiveness. Company Drive-In sales decreased \$5.5 million during the third quarter and \$41.3 million during the first nine months of fiscal year 2018 as compared to the same periods last year. The decrease in Company Drive-In sales in the third quarter and first nine months of fiscal year 2018 is primarily due to the sale of certain Company Drive-Ins to franchisees. Associated sales declines related to those divestitures were \$5.3 million and \$38.8 million for the third quarter and first nine months of fiscal year 2018, respectively.

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The following table reflects the change in franchise sales, the number of Franchise Drive-Ins, average unit volumes and franchising revenues. While we do not record Franchise Drive-In sales as revenues, we believe this information is important in understanding our financial performance since these sales are the basis on which we calculate and record franchise royalties. This information is also indicative of the financial health of our franchisees.

Franchise Information

(\$ in thousands)

	Three months ended		Nine months ended	
	May 31, 2018	2017	May 31, 2018	2017
Franchise Drive-In sales	\$ 1,163,863	\$ 1,145,042	\$ 3,010,081	\$ 2,971,775
Percentage increase	1.6	% 3.4	% 1.3	% 0.3
Franchise Drive-Ins in operation ⁽¹⁾ :				
Total at beginning of period	3,365	3,329	3,365	3,212
Opened	5	13	18	36
Acquired from the Company	43	5	49	115
Closed (net of re-openings)	(3) (6) (22) (22
Total at end of period	3,410	3,341	3,410	3,341
Average sales per Franchise Drive-In	349	348	906	915
Change in same-store sales ⁽²⁾	(0.2)% (1.1)% (1.4)% (3.2
Franchising revenues ⁽³⁾	\$ 50,454	\$ 50,638	\$ 128,054	\$ 128,161
Percentage increase (decrease)	(0.4)% 3.7	% (0.1)% 0.3
Effective royalty rate ⁽⁴⁾	4.13	% 4.18	% 4.06	% 4.10

(1) Drive-ins that are temporarily closed for various reasons (repairs, remodeling, relocations, etc.) are not considered closed unless the Company determines they are unlikely to reopen within a reasonable time.

(2) Represents percentage change for drive-ins open for a minimum of 15 months.

(3) Consists of revenues derived from franchising activities, including royalties, franchise fees and lease revenues. See Revenue Recognition Related to Franchise Fees and Royalties in the Critical Accounting Policies and Estimates section of Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended August 31, 2017.

(4) Represents franchise royalties as a percentage of Franchise Drive-In sales.

Same-store sales for Franchise Drive-Ins decreased 0.2% for the third quarter and 1.4% for the first nine months of fiscal year 2018 as compared to a decrease of 1.1% and 3.2%, respectively, for the same periods last year, reflecting adverse weather as well as aggressive competitive activity in the first half of the fiscal year, partially offset by positive momentum from Company initiatives in the third fiscal quarter. We continue to focus on our innovative product pipeline, multi-day-part promotions and increased media effectiveness. Franchising revenues decreased \$0.2 million, or 0.4%, for the third quarter of fiscal year 2018 and \$0.1 million, or 0.1%, for the first nine months of fiscal year 2018 compared to the same period last year. For the third quarter and first nine months of fiscal year 2018, franchise royalties were positively impacted by franchisee acquisitions of Company Drive-ins and net new unit growth, partially offset by incentives offered to franchisees and the impact of the decrease in same-store sales.

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Operating Expenses. The following table presents the overall costs of drive-in operations as a percentage of Company Drive-In sales. Other operating expenses include direct operating costs such as marketing, telephone and utilities, repair and maintenance, rent, property tax and other controllable expenses.

Company Drive-In Margins

	Three months		Percentage Points Increase (Decrease)
	ended May 31, 2018	ended May 31, 2017	
Costs and expenses			
Company Drive-Ins:			
Food and packaging	27.9%	26.9%	1.0
Payroll and other employee benefits	35.2	35.5	(0.3)
Other operating expenses	18.6	19.2	(0.6)
Cost of Company Drive-In sales	81.7%	81.6%	0.1
	Nine months		
	ended	ended	Percentage Points
	May 31,	May 31,	Increase (Decrease)
	2018	2017	
Costs and expenses			
Company Drive-Ins:			
Food and packaging	27.9%	27.3%	0.6
Payroll and other employee benefits	36.9	37.0	(0.1)
Other operating expenses	20.5	21.3	(0.8)
Cost of Company Drive-In sales	85.3%	85.6%	(0.3)

Drive-in level margins at Company Drive-Ins were unfavorable by 10 basis points during the third quarter and were favorable by 30 basis points during the first nine months of fiscal year 2018. Sequentially improving sales in the later portion of the quarter resulted in less de-leveraging on overall drive-in level margins. Food and packaging costs were unfavorable by 100 basis points during the third quarter of fiscal year 2018 and by 60 basis points during the first nine months of fiscal year 2018 as a result of commodity cost inflation and a higher level of discounting as compared to the prior-year period. Payroll and other employee benefits were favorable by 30 basis points for the third quarter of fiscal year 2018 and by 10 basis points during the first nine months of fiscal year 2018, reflecting more effective management of labor expenses and the impact of refranchising underperforming drive-ins and drive-ins in higher-cost labor markets. Other operating expenses were favorable by 60 basis points during the third quarter of fiscal year 2018 and by 80 basis points during the first nine months of fiscal year 2018, driven by the impact of refranchising underperforming drive-ins and more effective management of operating expenses.

Selling, General and Administrative (“SG&A”). SG&A expenses increased \$0.4 million, or 1.7%, to \$21.1 million for the third quarter and decreased \$1.1 million, or 1.8%, to \$57.7 million for the first nine months of fiscal year 2018, as compared to the same periods last year. The year-to-date decrease reflects expense reduction initiatives taken at the end of the prior fiscal year and general cost control during the periods.

Depreciation and Amortization. Depreciation and amortization was flat at \$9.6 million in the third quarter and decreased \$1.0 million, or 3.5%, to \$28.5 million for the first nine months of fiscal year 2018, as compared to the same periods last year. This is primarily attributable to a decrease in Company assets related to the refranchising of certain Company Drive-Ins in the first half of fiscal year 2017 and the third quarter of fiscal year 2018, disposition of real estate in the last quarter of fiscal year 2017 and assets that fully depreciated in the prior fiscal year, partially offset

by an increase in technology assets.

Net Interest Expense. Net interest expense increased \$1.0 million, or 14.9%, to \$8.1 million for the third quarter and \$3.7 million, or 17.8%, to \$24.4 million for the first nine months of fiscal year 2018, as compared to the same periods last year. The increase reflects additional interest expense related to the increase in the long-term debt balance.

Additionally, the net interest expense includes the \$1.3 million loss on debt transactions related to the commitment reduction of the Series 2016-1 Senior Secured Variable Funding Notes, Class A-1 (the “2016 Variable Funding Notes”), as well as the pro rata prepayment on the Series 2016-1 Senior Secured Fixed Rate Notes, Class A-2 (the “2016 Fixed Rate Notes”) and Series 2013-1 Senior Secured Fixed Rate Notes, Class A-2 (the “2013 Fixed Rate Notes”). The increase was also impacted by the net borrowings on the 2016 Variable Funding Notes during the first nine months of fiscal year 2018, as compared to less borrowings on the 2016 Variable

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Funding Notes in the same periods last year. See “Liquidity and Sources of Capital” and “Item 3. Quantitative and Qualitative Disclosures About Market Risk” below for additional information on our debt financing transactions and factors that could impact interest expense.

Income Taxes. The provision for income taxes reflects an effective tax rate of 26.1% for the third quarter of fiscal year 2018 compared to 34.0% for the same period in 2017. The provision for income taxes reflects an effective tax rate of (4.7)% for the first nine months of fiscal 2018 compared to 33.5% for the same period in 2017. The lower effective income tax rate during the third quarter and first nine months of fiscal year 2018 was due primarily to the impacts of the TCJA. Specifically, the lower effective income tax rate during the third quarter of fiscal year 2018 was due primarily to the reduction of the U.S. corporate federal income tax rate from 35% in fiscal year 2017 to a blended statutory rate of 25.7% in fiscal year 2018. The lower effective income tax rate during the first nine months of fiscal year 2018 was due primarily to the lower U.S. corporate federal statutory income tax rate and the recognition of a provisional income tax benefit of \$14.1 million in the second quarter of fiscal year 2018 resulting from the revaluation of our deferred income tax assets and liabilities. Please refer to Note 4 - Income Taxes, included in Part I, Item 1, "Financial Statements," in this Quarterly Report on Form 10-Q for a discussion of the impacts of the TCJA. Our tax rate may continue to vary from quarter to quarter depending on the timing of stock option dispositions by option holders and as circumstances on other tax matters change.

Non-GAAP Adjustments. Excluding the non-GAAP adjustments further described below, net income for the third quarter of fiscal year 2018 increased 7% and diluted earnings per share for the quarter increased 21% to \$0.52. Net income and diluted earnings per share for the first nine months of fiscal year 2018 would have increased 5% and 21%, respectively. The lower tax rate resulting from the federal tax reform benefited adjusted earnings per share by approximately \$0.06 for the third quarter and \$0.10 for the first nine months of fiscal year 2018. Excluding the total impact of federal tax reform, adjusted net income per diluted share improved 7% to \$0.46 in the third quarter and 9% to \$0.88 in the first nine months of fiscal year 2018.

The following analysis of non-GAAP adjustments is intended to supplement the presentation of the Company’s financial results in accordance with GAAP. We believe the exclusion of these items in evaluating the change in net income and diluted earnings per share for the periods below provides useful information to investors and management regarding the underlying business trends and the performance of our ongoing operations and is helpful for period-to-period and company-to-company comparisons, which management believes will assist investors in analyzing the financial results for the Company and predicting future performance.

(In thousands, except per share amounts)

	Three months ended May 31, 2018		Three months ended May 31, 2017	
	Net Income	Diluted EPS	Net Income	Diluted EPS
Reported – GAAP	\$21,576	\$0.58	\$18,751	\$0.44
Payment card breach expense ⁽¹⁾	338	0.01	—	—
Tax impact on payment card breach expense ⁽²⁾	(99)	0.00	—	—
Net gain on refranchising transactions ⁽³⁾	(3,153)	(0.08)	(814)	(0.02)
Tax impact on refranchising transactions ⁽⁴⁾	924	0.02	396	0.01
Adjusted - Non-GAAP ⁽⁵⁾	\$19,586	\$0.52	\$18,333	\$0.43

(1) Costs include legal fees.

(2) Tax impact during the period at a consolidated blended statutory tax rate of 29.3%.

- During the third quarter of fiscal year 2018, we completed transactions to rebrand the operations of 41 Company Drive-Ins. During the first and second quarters of fiscal year 2017, we completed transactions to rebrand the operations of 110 Company Drive-Ins. Refer to Note 10 - Rebranding Initiative, included in Part I, Item 1, "Financial Statements," in this Quarterly Report on Form 10-Q for more information.
- (3) Tax impact at a consolidated blended statutory tax rate of 29.3% during fiscal year 2018 and at an adjusted effective tax rate of 48.7% during fiscal year 2017.
 - (4) Sum of per share data may not agree to the total amounts due to rounding.

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	Nine months ended May 31, 2018		Nine months ended May 31, 2017	
	Net Income	Diluted EPS	Net Income	Diluted EPS
Reported – GAAP	\$52,613	\$ 1.36	\$42,832	\$ 0.96
Payment card breach expense ⁽¹⁾	1,209	0.03	—	—
Tax impact on payment card breach expense ⁽²⁾	(411)	(0.01)	—	—
Loss from debt transactions ⁽³⁾	1,310	0.03	—	—
Tax impact on debt transactions ⁽⁴⁾	(384)	(0.01)	—	—
Discrete impact of the Tax Cuts and Jobs Act	(14,120)	(0.37)	—	—
Net gain on refranchising transactions ⁽⁵⁾	(3,153)	(0.08)	(6,645)	(0.15)
Tax impact on refranchising transactions ⁽⁶⁾	924	0.02	2,501	0.05
Gain on sale of investment in refranchised drive-in operations ⁽⁷⁾	—	—	(3,795)	(0.08)
Tax impact on sale of investment in refranchised drive-in operations ⁽⁸⁾	—	—	1,350	0.03
Adjusted - Non-GAAP ⁽⁹⁾	\$37,988	\$ 0.98	\$36,243	\$ 0.81

(1) Costs include legal fees, investigative fees and costs related to customer response.

(2) Combined tax impact at consolidated blended statutory tax rates of 38.2% during the first quarter of fiscal year 2018 and 29.3% during the second and third quarters of fiscal year 2018.

(3) Includes a \$0.7 million write-off of unamortized deferred loan fees related to the reduction of the Company's variable funding note commitments, as well as a \$0.4 million write-off of unamortized deferred loan fees related to the prepayment on its 2013 Fixed Rate Notes and 2016 Fixed Rate Notes. Additionally, as required by the terms of the 2016 Fixed Rate Notes, we paid a \$0.2 million prepayment premium.

(4) Tax impact during the period at a consolidated blended statutory tax rate of 29.3%.

(5) During the third quarter of fiscal year 2018, we completed transactions to refranchise the operations of 41 Company Drive-Ins. During the first and second quarters of fiscal year 2017, we completed transactions to refranchise the operations of 110 Company Drive-Ins. Refer to Note 10 - Refranchising Initiative, included in Part I, Item 1, "Financial Statements," in this Quarterly Report on Form 10-Q for more information.

(6) Tax impact at a consolidated blended statutory tax rate of 29.3% during fiscal year 2018; a combined tax impact at an effective tax rate of 35.6% during the first quarter of fiscal year 2017 and at adjusted effective tax rates of 36.0% and 48.7% during the second and third quarters of fiscal year 2017, respectively.

(7) Gain on sale of investment in refranchised drive-ins is related to minority investments in franchise operations retained as part of a refranchising transaction that occurred in fiscal year 2009.

(8) Tax impact during the period at an adjusted effective tax rate of 35.6%.

(9) Sum of per share data may not agree to the total amounts due to rounding.

Financial Position

Total assets decreased \$16.2 million, or 2.9%, to \$545.5 million during the first nine months of fiscal year 2018 from \$561.7 million at the end of fiscal year 2017. The decrease in total assets was driven by a decrease in property, equipment and capital leases primarily driven by refranchising transactions, as well as depreciation, partially offset by capital expenditures and a decrease in assets held for sale. Additionally, there was an increase in notes receivable, primarily related to notes extended to the system marketing funds and franchisees and an increase in royalties and other trade receivables reflective of higher total sales compared to sales at the end of the prior fiscal year.

Total liabilities increased \$55.3 million, or 7.2%, to \$818.8 million during the first nine months of fiscal year 2018 from \$763.5 million at the end of fiscal year 2017. The increase was primarily attributable to an increase in long-term debt of \$79.1 million related to the 2018 debt transactions, detailed below in "Liquidity and Sources of Capital." This

was partially offset by a decrease of \$14.4 million in deferred income taxes as a result of the TCJA and of \$6.5 million in accrued liabilities, which is mainly related to payment of wages and incentive compensation and other tax liabilities that were accrued as of August 31, 2017.

Total stockholders' deficit increased \$71.5 million, or 35.4%, to a deficit of \$273.3 million during the first nine months of fiscal year 2018 from a deficit of \$201.8 million at the end of fiscal year 2017. This increase was primarily attributable to \$109.1 million in purchases of common stock during the first nine months of the fiscal year and the payment of \$18.2 million in dividends, partially offset by current-year earnings of \$52.6 million.

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Liquidity and Sources of Capital

Operating Cash Flows. Net cash provided by operating activities increased \$14.8 million to \$64.8 million for the first nine months of fiscal year 2018 as compared to \$50.1 million for the same period in fiscal year 2017. The increase was mainly due to changes in working capital, primarily related to higher incentive compensation paid in the prior fiscal year period, as well as the timing of payments for operational, payroll and tax transactions. Operating cash flow was also impacted by an increase of \$4.0 million in net income, excluding the non-cash items for gain on disposition of assets and the benefit from deferred income taxes.

Investing Cash Flows. Net cash used in investing activities was \$15.5 million for the first nine months of fiscal year 2018 as compared to net cash provided by investing activities of \$44.2 million for the same period in fiscal year 2017. Proceeds declined \$54.5 million from the \$70.7 million received during the first nine months of fiscal year 2017. The increased activity in fiscal year 2017 resulted from the sale of assets related to stores sold to franchisees as part of the refranchising initiative and the sale of investment in refranchised drive-in operations. Additionally, we had decreased investments in property and equipment of \$12.6 million, mainly due to an \$18.9 million decrease related to the timing of rebuilds, relocations and remodels of existing drive-ins and newly constructed drive-ins for the Company and franchisees. This was partially offset by an increase of \$7.6 million in acquisition of real estate.

The table below outlines our use of cash in millions for investments in property and equipment for the first nine months of fiscal year 2018:

Brand technology investments	\$9.1
Acquisition of real estate	7.6
Purchase and replacement of equipment and technology	4.5
Rebuilds, relocations and remodels of existing drive-ins	2.5
Newly constructed drive-ins leased or sold to franchisees	0.8
Total investments in property and equipment	\$24.5

Financing Cash Flows. Net cash used by financing activities decreased \$87.5 million to \$26.8 million for the first nine months of fiscal year 2018, as compared to cash used in financing activities of \$114.3 million for the same period in fiscal year 2017. In February of fiscal year 2018 we completed a debt financing transaction as described below, which is the primary driver of the increase. Additionally, there was a decrease in purchases of treasury stock of \$17.6 million compared to the prior-year period.

During the second quarter of fiscal year 2018, we used a portion of the restricted funds from the proceeds of the sale of securitized assets during fiscal year 2017 to make a pro rata prepayment of \$28.0 million on our 2013 Fixed Rate Notes and 2016 Fixed Rate Notes. The prepayment was made at par, as allowed under the note terms.

On February 1, 2018, various subsidiaries (the “Co-Issuers”) issued \$170.0 million of Series 2018-1 Senior Secured Fixed Rate Notes, Class A-2 (the “2018 Fixed Rate Notes”) in a private transaction which bears interest at 4.03% per annum. The 2018 Fixed Rate Notes have an expected life of seven years with an anticipated repayment date in February 2025. At May 31, 2018, the balance outstanding under the 2018 Fixed Rate Notes including accrued interest totaled \$170.2 million and carried a weighted-average interest cost of 4.40%, including the effect of the loan origination costs described below.

We used a portion of the net proceeds from the issuance of the 2018 Fixed Rate Notes to pay down the outstanding portion of the 2016 Variable Funding Notes and to pay the costs associated with the securitized financing transaction. In conjunction with the issuance of the 2018 Fixed Rate Notes, the commitments under the 2016 Variable Funding Notes were reduced to \$100.0 million.

Loan origination costs associated with the 2018 Fixed Rate Notes totaled \$5.0 million. Loan costs are amortized over each note's expected life, and the unamortized balance related to the 2016 Variable Funding Notes and the Fixed Rate Notes is included in debt origination costs, net and long-term debt, net, respectively, on the condensed consolidated balance sheets.

In connection with the 2018 transactions described above, we recognized a \$1.3 million loss during the second quarter of fiscal year 2018. The loss consisted of a \$0.7 million write-off of unamortized deferred debt origination costs related to the reduction of the 2016 Variable Funding Notes commitments, as well as a \$0.4 million write-off of unamortized deferred debt origination costs related to the prepayment on our 2013 Fixed Rate Notes and 2016 Fixed Rate Notes. Additionally, as required by the terms of the 2016 Fixed Rate Notes, we paid a \$0.2 million prepayment premium.

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While the 2018 Fixed Rate Notes have an expected life of seven years, they have a legal final maturity date of February 2048. We intend to repay or refinance the 2018 Fixed Rate Notes on or before the end of their respective expected life. In the event the 2018 Fixed Rate Notes are not paid in full by the end of their expected life, the Notes are subject to an upward adjustment in the annual interest rate of at least 5%. In addition, principal payments will accelerate by applying all of the royalties, lease revenues and other fees securing the debt, after deducting certain expenses, until the debt is paid in full. Also, any unfunded amount under the 2016 Variable Funding Notes will become unavailable.

We anticipate fiscal year 2018 interest expense from the 2018 Fixed Rate Notes, the 2016 Fixed Rate Notes and the 2013 Fixed Rate Notes (collectively, the “Fixed Rate Notes”), including the amortization of loan origination costs, to be approximately \$30.8 million annually. As a result of an amortization requirement based on a leverage ratio calculation, we will be making principal payments of \$5.3 million over the next twelve months on the 2016 Fixed Rate Notes. For additional information on our 2018 transactions see note 8 – Debt, included in Part I, Item 1, “Financial Statements” in this Quarterly Report on Form 10-Q. See note 10 - Long-Term Debt in the Notes to Consolidated Financial Statements in the Company's Annual Report on Form 10-K for the fiscal year ended August 31, 2017 for additional information regarding our long-term debt.

During fiscal year 2017, approximately 6.7 million shares were repurchased under our share repurchase program for a total cost of \$172.9 million, resulting in an average price per share of \$25.71. In August 2017, the Board of Directors approved an incremental \$160.0 million share repurchase authorization of the Company's outstanding shares of common stock through August 31, 2018.

During the first nine months of fiscal year 2018, approximately 4.3 million shares were repurchased for a total cost of \$109.1 million, resulting in an average price per share of \$25.23. The total remaining authorized under the share repurchase program as of May 31, 2018 was \$50.9 million.

Subsequent to the end of the quarter, the Board of Directors authorized a \$500.0 million share repurchase program through August 31, 2021, replacing the Company's previous fiscal year 2018 authorization. Including amounts purchased during the first nine months of the fiscal year, the total remaining authorized under the share repurchase program is \$390.9 million.

As of May 31, 2018, our total cash balance of \$73.3 million (\$44.9 million of unrestricted and \$28.5 million of restricted cash balances) reflected the impact of the cash generated from operating activities, net proceeds from the 2018 debt transactions and cash used for share repurchases, dividends and capital expenditures mentioned above. We believe that existing cash, funds generated from operations and the amount available under our 2016 Variable Funding Notes will meet our needs for the foreseeable future.

Critical Accounting Policies and Estimates

Critical accounting policies are those the Company believes are most important to portraying its financial condition and results of operations and also require the greatest amount of subjective or complex judgments by management.

Judgments and uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. There have been no material changes to the critical accounting policies previously disclosed in our Annual Report on Form 10-K for the fiscal year ended August 31, 2017.

New Accounting Pronouncements

For a description of new accounting pronouncements, see note 1 - Basis of Presentation, included in Part I, Item 1, "Financial Statements," in this Quarterly Report on Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There has been no material change in the quantitative and qualitative market risks set forth in Part II, Item 7A, "Quantitative and Qualitative Disclosures About Market Risk" in our Annual Report on Form 10-K for the year ended August 31, 2017.

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Item 4. Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-14 under the Securities Exchange Act of 1934). Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives. Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective at the reasonable assurance level.

There were no significant changes in the Company's internal control over financial reporting during the quarter ended May 31, 2018, that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

On October 4, 2017, the Company issued a public statement notifying guests that it had discovered that credit and debit card numbers may have been acquired without authorization as part of a malware attack experienced at certain Sonic Drive-In locations. As we reported in our Annual Report on Form 10-K for the year ended August 31, 2017, the Company was named as a defendant in five purported class action complaints. The Company has since been named as a defendant in four additional purported class action complaints filed on October 9, 2017, in the United States District Court for the Northern District of Ohio, on November 3, 2017, in the United States District Court for the Northern District of Texas, on November 13, 2017, in the United States District Court for the District of Arizona, and on December 17, 2017, in the Northern District of Illinois. Each of these complaints asserted various claims related to the Company's alleged failure to safeguard customer credit card information, and the plaintiffs sought monetary damages, injunctive and declaratory relief and attorneys' fees and costs. The cases were centralized in the Northern District of Ohio for coordinated or consolidated pretrial proceedings, and a consolidated complaint was filed. The Company believes it has meritorious defenses to the litigation and intends to vigorously oppose the claims asserted in the complaint. We cannot reasonably estimate the range of potential losses that may be associated with the litigation because of the early stage of the lawsuit. We also cannot provide assurance that we will not become subject to other inquiries or claims relating to the payment card breach in the future. Although we maintain cyber liability insurance, we currently believe it is possible that the ultimate amount paid by us, if we are unsuccessful in defending the litigation, will be in excess of our cyber liability insurance coverage applicable to claims of this nature. We are unable to estimate the amount of any such excess.

The Company is involved in various legal proceedings and has certain unresolved claims pending. Based on the information currently available, management believes that all claims currently pending are either covered by insurance or would not have a material adverse effect on the Company's business, operating results or financial condition.

Item 1A. Risk Factors

There has been no material change in the risk factors set forth in Part I, Item 1A, "Risk Factors" in our Annual Report on Form 10-K for the year ended August 31, 2017.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(c) Issuer Purchases of Equity Securities

Shares repurchased during the third quarter of fiscal year 2018 are as follows (in thousands, except per share amounts):

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Dollar Value that May Yet Be Purchased Under the Program ⁽¹⁾
March 1, 2018 through March 31, 2018	544	\$ 24.95	544	\$ 74,938
April 1, 2018 through April 30, 2018	372	26.35	372	65,144
May 1, 2018 through May 31, 2018	572	24.90	572	50,899
Total	1,488		1,488	

In August 2017, the Company's Board of Directors extended the Company's share repurchase program, authorizing the Company to purchase up to \$160.0 million of its outstanding shares of common stock through August 31, 2018. In June 2018, the Board of Directors authorized a \$500.0 million share repurchase program through August 31, 2021, replacing the Company's previous fiscal year 2018 authorization.

Share repurchases may be made from time to time in the open market or otherwise, including through an accelerated share repurchase program, under terms of a Rule 10b5-1 plan, in privately negotiated transactions or in round lot or block transactions. The share repurchase program may be extended, modified, suspended or discontinued at any time. Please refer to note 3 – Share Repurchase Program included in Part I, Item 1, "Financial Statements" in this Quarterly Report on Form 10-Q for additional information.

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Item 6. Exhibits

Exhibits.

- 31.01 Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14
- 31.02 Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14
- 32.01 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
- 32.02 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
- 101.INS XBRL Instance Document
- 101.SCHXBRL Taxonomy Extension Schema Document
- 101.CALXBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101.LABXBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

SONIC CORP.

By: /s/ Corey R. Horsch
Corey R. Horsch
Vice President, Chief Financial Officer
and Treasurer

Date: July 3, 2018

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EXHIBIT INDEX

Exhibit Number and Description

31.01	Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14
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32.02	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document