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APPLEBEES INTERNATIONAL INC

Form 10-Q

July 29, 2004

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 June 27, 2004

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: 000-17962

Applebee's International, Inc.

(Exact name of registrant as specified in its charter)

Delaware

43-1461763

(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer Identification No.)

4551 W. 107th Street, Overland Park, Kansas 66207

(Address of principal executive offices and zip code)

(913) 967-4000

(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 ☒ No ☐

Indicate by check mark whether the registrant is an accelerated filer (as  
defined by Rule 12b-2 of the Act). Yes ☒ No ☐

The number of shares of the registrant's common stock outstanding as of July 23,  
2004 was 82,083,020.

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES FORM 10-Q FISCAL QUARTER ENDED JUNE 27, 2004 INDEX

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (Unaudited)

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(in thousands, except share amounts)

## ASSETS

### Current assets:

Cash and cash equivalents.....  
Short-term investments, at market value.....  
Receivables (less allowance for bad debts of \$4,401 in 2004 and \$4,117 in 2003).....  
Receivables related to captive insurance subsidiary.....  
Inventories.....  
Prepaid income taxes.....  
Other current assets related to captive insurance subsidiary.....  
Prepaid and other current assets.....

Total current assets.....  
Property and equipment, net.....  
Goodwill.....  
Restricted assets related to captive insurance subsidiary.....  
Other intangible assets, net.....  
Other assets.....

## LIABILITIES AND STOCKHOLDERS' EQUITY

### Current liabilities:

Current portion of long-term debt.....  
Accounts payable.....  
Accrued expenses and other current liabilities.....  
Loss reserve and unearned premiums related to captive insurance subsidiary.....  
Accrued income taxes.....  
Accrued dividends.....

Total current liabilities.....

### Non-current liabilities:

Long-term debt - less current portion.....  
Other non-current liabilities.....

Total non-current liabilities.....

Total liabilities.....

### Commitments and contingencies (Note 3)

#### Stockholders' equity:

Preferred stock - par value \$0.01 per share: authorized - 1,000,000 shares;  
no shares issued.....  
Common stock - par value \$0.01 per share: authorized - 125,000,000 shares;  
issued - 108,503,243 shares.....  
Additional paid-in capital.....  
Retained earnings.....

Treasury stock - 26,631,822 shares in 2004 and 25,715,767 shares in 2003, at  
cost.....

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Total stockholders' equity.....

See notes to consolidated financial statements.

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited) (in thousands, except per share amounts)

|                                                       | 13 Weeks Ended   |                  |
|-------------------------------------------------------|------------------|------------------|
|                                                       | June 27,<br>2004 | June 29,<br>2003 |
| Revenues:                                             |                  |                  |
| Company restaurant sales .....                        | \$ 247,769       | \$ 220,107       |
| Franchise royalties and fees.....                     | 30,779           | 27,331           |
| Other franchise income.....                           | 3,399            | 3,268            |
| Total operating revenues.....                         | 281,947          | 250,706          |
| Cost of company restaurant sales:                     |                  |                  |
| Food and beverage.....                                | 66,647           | 57,040           |
| Labor.....                                            | 81,086           | 71,804           |
| Direct and occupancy.....                             | 60,240           | 54,386           |
| Pre-opening expense.....                              | 391              | 334              |
| Total cost of company restaurant sales.....           | 208,364          | 183,564          |
| Cost of other franchise income.....                   | 5,035            | 3,173            |
| General and administrative expenses.....              | 24,932           | 22,887           |
| Amortization of intangible assets.....                | 158              | 92               |
| Loss on disposition of restaurants and equipment..... | 584              | 731              |
| Operating earnings.....                               | 42,874           | 40,259           |
| Other income (expense):                               |                  |                  |
| Investment income.....                                | 18               | 485              |
| Interest expense.....                                 | (416)            | (518)            |
| Impairment of Chevys note receivable (Note 9).....    | --               | (8,803)          |
| Other income.....                                     | 951              | 1                |
| Total other income (expense).....                     | 553              | (8,835)          |
| Earnings before income taxes.....                     | 43,427           | 31,424           |
| Income taxes.....                                     | 15,200           | 11,239           |
| Net earnings.....                                     | \$ 28,227        | \$ 20,185        |

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|                                                  |         |         |
|--------------------------------------------------|---------|---------|
| Basic net earnings per common share.....         | \$ 0.35 | \$ 0.24 |
|                                                  | =====   | =====   |
| Diluted net earnings per common share.....       | \$ 0.34 | \$ 0.24 |
|                                                  | =====   | =====   |
| Basic weighted average shares outstanding.....   | 81,781  | 83,153  |
|                                                  | =====   | =====   |
| Diluted weighted average shares outstanding..... | 84,098  | 85,548  |
|                                                  | =====   | =====   |

See notes to consolidated financial statements.

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY (Unaudited) (in thousands, except share amounts)

|                                                                                        | Common Stock |          | Additional         | Retained   |
|----------------------------------------------------------------------------------------|--------------|----------|--------------------|------------|
|                                                                                        | Shares       | Amount   | Paid-In<br>Capital | Earnings   |
|                                                                                        | -----        | -----    | -----              | -----      |
| Balance, December 28, 2003.....                                                        | 108,503,243  | \$ 1,085 | \$ 200,574         | \$ 523,954 |
| Net earnings.....                                                                      | --           | --       | --                 | 57,730     |
| Purchases of treasury stock.....                                                       | --           | --       | --                 | --         |
| Stock options exercised and<br>related tax benefit.....                                | --           | --       | 6,596              | --         |
| Shares issued under employee<br>benefit plans.....                                     | --           | --       | 2,603              | --         |
| Restricted shares awarded<br>under equity incentive plan,<br>net of cancellations..... | --           | --       | (404)              | --         |
| Amortization of unearned<br>compensation relating to<br>restricted shares.....         | --           | --       | 695                | --         |
| Dividends paid for fractional<br>shares.....                                           | --           | --       | --                 | (48)       |
|                                                                                        | -----        | -----    | -----              | -----      |
| Balance, June 27, 2004.....                                                            | 108,503,243  | \$ 1,085 | \$ 210,064         | \$ 581,636 |
|                                                                                        | =====        | =====    | =====              | =====      |

See notes to consolidated financial statements.

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### APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited) (in thousands)

#### CASH FLOWS FROM OPERATING ACTIVITIES:

|                                                                                     |  |
|-------------------------------------------------------------------------------------|--|
| Net earnings.....                                                                   |  |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |  |
| Depreciation and amortization.....                                                  |  |
| Amortization of intangible assets.....                                              |  |
| Amortization of unearned compensation.....                                          |  |
| Other amortization.....                                                             |  |
| Inventory impairment.....                                                           |  |
| Deferred income tax benefit.....                                                    |  |
| Gain on sale of investments.....                                                    |  |
| Loss on disposition of restaurants and equipment.....                               |  |
| Impairment of Chevys note receivable.....                                           |  |
| Income tax benefit from exercise of stock options.....                              |  |
| Changes in assets and liabilities (exclusive of effects of acquisitions):           |  |
| Receivables.....                                                                    |  |
| Receivables related to captive insurance subsidiary.....                            |  |
| Inventories.....                                                                    |  |
| Prepaid income taxes.....                                                           |  |
| Other current assets related to captive insurance subsidiary.....                   |  |
| Prepaid and other current assets.....                                               |  |
| Accounts payable.....                                                               |  |
| Accrued expenses and other current liabilities.....                                 |  |
| Loss reserve and unearned premiums related to captive insurance subsidiary.....     |  |
| Accrued income taxes.....                                                           |  |
| Other.....                                                                          |  |
| NET CASH PROVIDED BY OPERATING ACTIVITIES.....                                      |  |

#### CASH FLOWS FROM INVESTING ACTIVITIES:

|                                                                |  |
|----------------------------------------------------------------|--|
| Purchases of property and equipment.....                       |  |
| Restricted assets related to captive insurance subsidiary..... |  |
| Acquisition of restaurants.....                                |  |
| Lease acquisition costs.....                                   |  |
| Purchases of short-term investments.....                       |  |
| Proceeds from sale of restaurants and equipment.....           |  |
| Maturities and sales of short-term investments.....            |  |
| Other investing activities.....                                |  |
| NET CASH USED BY INVESTING ACTIVITIES.....                     |  |

#### CASH FLOWS FROM FINANCING ACTIVITIES:

|                                                              |  |
|--------------------------------------------------------------|--|
| Purchases of treasury stock.....                             |  |
| Dividends paid.....                                          |  |
| Issuance of common stock upon exercise of stock options..... |  |
| Shares issued under employee benefit plans.....              |  |
| Net long-term debt proceeds (payments).....                  |  |
| NET CASH USED BY FINANCING ACTIVITIES.....                   |  |

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NET DECREASE IN CASH AND CASH EQUIVALENTS.....  
 CASH AND CASH EQUIVALENTS, beginning of period.....  
 CASH AND CASH EQUIVALENTS, end of period.....

See notes to consolidated financial statements.

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS - (Continued) (Unaudited) (in thousands)

### SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

Cash paid during the 26 week period for:

|                   |      |
|-------------------|------|
| Income taxes..... | \$ 7 |
| Interest.....     | \$ 3 |

### SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:

We issued restricted common stock, net of forfeitures, of \$1,497,000 and \$1,618,000 for the 26 weeks ended June 27, 2004 and June 29, 2003, respectively.

On March 24, 2003, we assumed a loan of approximately \$1,400,000 in connection with the acquisition of 11 restaurants.

### DISCLOSURE OF ACCOUNTING POLICY:

For purposes of the consolidated statements of cash flows, we consider all highly liquid investments purchased with a maturity of three months or less to be cash equivalents.

See notes to consolidated financial statements.

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## APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Unaudited)

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## 1. Basis of Presentation

Our consolidated financial statements included in this Form 10-Q have been prepared without audit (except that the balance sheet information as of December 28, 2003 has been derived from consolidated financial statements which were audited) in accordance with the rules and regulations of the Securities and Exchange Commission. Although certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted, we believe that the disclosures are adequate to make the information presented not misleading. The accompanying consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 28, 2003.

We believe that all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented have been made. The results of operations for the interim periods presented are not necessarily indicative of the results to be expected for the full year.

We have made certain reclassifications to the prior periods' consolidated financial statements to conform to the 2004 presentation.

## 2. Stock-Based Compensation

We have adopted the disclosure provisions of Statement of Financial Accounting Standards ("SFAS") No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123." The Statement requires prominent disclosures in both annual and interim financial statements regarding the method of accounting for stock-based employee compensation and the effect of the method used on reported results. We account for stock-based compensation awards under the intrinsic method of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees." Opinion No. 25 requires compensation cost to be recognized based on the excess, if any, between the quoted market price of the stock at the date of grant and the amount an employee must pay to acquire the stock. All options awarded under all of our plans are granted with an exercise price equal to the fair market value on the date of the grant. The following table presents the effect on our net earnings and earnings per share had we adopted the fair value method of accounting for stock-based compensation under SFAS No. 123, "Accounting for Stock-Based Compensation" (in thousands, except for per share amounts).

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|                                                                                                                    | 13 Weeks Ended   |                  |
|--------------------------------------------------------------------------------------------------------------------|------------------|------------------|
|                                                                                                                    | June 27,<br>2004 | June 29,<br>2003 |
| Net earnings, as reported.....                                                                                     | \$ 28,227        | \$ 20,185        |
| Add: Stock-based employee compensation expense<br>(benefit) included in net earnings,<br>net of related taxes..... | (12)             | 506              |
| Less: Total stock-based employee                                                                                   |                  |                  |

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|                                                                                                                |           |           |    |
|----------------------------------------------------------------------------------------------------------------|-----------|-----------|----|
| compensation expense determined under<br>fair value based methods for all awards,<br>net of related taxes..... | 2,155     | 2,429     |    |
| Pro forma net earnings.....                                                                                    | \$ 26,060 | \$ 18,262 | \$ |
| Basic net earnings per common share,<br>as reported.....                                                       | \$ 0.35   | \$ 0.24   | \$ |
| Basic net earnings per common share,<br>pro forma.....                                                         | \$ 0.32   | \$ 0.22   | \$ |
| Diluted net earnings per common share,<br>as reported.....                                                     | \$ 0.34   | \$ 0.24   | \$ |
| Diluted net earnings per common share,<br>pro forma.....                                                       | \$ 0.31   | \$ 0.21   | \$ |

### 3. Commitments and Contingencies

**Litigation, claims and disputes:** We are involved in various legal actions which include, without limitation, employment law related matters, dram shop claims, personal injury claims and other such normal restaurant operational matters. In each instance, we believe that we have meritorious defenses to the allegations made and we are vigorously defending these claims.

While the resolution of the matters described above may have an impact on our financial results for the period in which they are resolved, we believe that the ultimate disposition of these matters will not, individually or in the aggregate, have a material adverse effect upon our business or consolidated financial statements.

**Lease guarantees:** In connection with the sale of restaurants to franchisees and other parties, we have, in certain cases, remained contingently liable for the remaining lease payments. As of June 27, 2004, the aggregate amount of these lease payments totaled approximately \$19,800,000. These leases expire at various times throughout the next several years with the final lease agreement expiring in 2025. The buyers have indemnified us from any losses related to these guarantees. We have not recorded a liability as of June 27, 2004 or December 28, 2003.

**Franchisee guarantees:** In November 2003, we arranged for a financing company to provide up to \$75,000,000 to qualified franchisees for short-term loans to fund remodel investments. Under the terms of this financing program, we will provide a limited guarantee pool for the loans advanced during the three-year period ending December 2006. There was one loan outstanding for approximately \$400,000 under this program as of June 27, 2004. The fair value of our guarantee was immaterial and accordingly, we have not recorded a liability as of June 27, 2004.

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In May 2004, we arranged for a financing company to provide up to \$250,000,000 to qualified franchisees for loans to fund development of new restaurants through October 2007. We will provide a limited guarantee of certain loans advanced under this program. As of June 27, 2004, there were no loans outstanding under this program.

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Severance agreements: We have severance and employment agreements with certain officers and other senior executives providing for severance payments to be made in the event the employee resigns or is terminated related to a change in control. The agreements define the circumstances which will constitute a change in control. If the severance payments had been due as of June 27, 2004, we would have been required to make payments totaling approximately \$12,200,000. In addition, we have severance and employment agreements with certain officers which contain severance provisions not related to a change in control. Those provisions would have required aggregate payments of approximately \$7,200,000 if such officers had been terminated as of June 27, 2004.

### 4. Earnings Per Share

We compute basic earnings per share by dividing income available to common shareholders 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 holders of options or other contracts to issue common stock exercised or converted their holdings into common stock. Outstanding stock options and equity-based compensation represent the only dilutive effects on weighted average shares. The chart below presents a reconciliation between basic and diluted weighted average shares outstanding and the related earnings per share. All amounts in the chart, except per share amounts, are expressed in thousands.

|                                                                        | 13 Weeks Ended   |                  |    |
|------------------------------------------------------------------------|------------------|------------------|----|
|                                                                        | June 27,<br>2004 | June 29,<br>2003 |    |
| Net earnings.....                                                      | \$ 28,227        | \$ 20,185        | \$ |
| Basic weighted average shares outstanding.....                         | 81,781           | 83,153           |    |
| Dilutive effect of stock options and<br>equity-based compensation..... | 2,317            | 2,395            |    |
| Diluted weighted average shares outstanding.....                       | 84,098           | 85,548           |    |
| Basic net earnings per common share.....                               | \$ 0.35          | \$ 0.24          | \$ |
| Diluted net earnings per common share.....                             | \$ 0.34          | \$ 0.24          | \$ |

We excluded stock options with exercise prices greater than the average market price of our common stock for the applicable periods from the computation of diluted weighted average shares outstanding. There were approximately 1,470,000 and 1,000 of these options for the 13 weeks ended June 27, 2004 and June 29, 2003, respectively, and 90,000 and 55,000 of these options for the 26 weeks ended June 27, 2004 and June 29, 2003, respectively.

### 5. Stock Split

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On May 13, 2004, we declared a three-for-two stock split, effected in the form of a 50% stock dividend, to shareholders of record on May 28, 2004 payable on June 15, 2004. We issued approximately 36,200,000 shares of common stock as a result of the stock split. All references to the number of shares and per share amounts of common stock have been restated to reflect the stock split. We have reclassified an amount equal to the par value of the number of shares issued to common stock from retained earnings.

### 6. Acquisitions

On April 26, 2004, we completed our acquisition of the operations and assets of 10 Applebee's restaurants located in Southern California for approximately \$13,700,000 in cash. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition. The purchase price was allocated to the fair value of property and equipment of \$2,500,000, goodwill of \$10,800,000 and other net assets of approximately \$400,000. We do not expect this transaction to have a significant impact on our net earnings for fiscal 2004.

On March 24, 2003, we acquired the operations and assets of 11 Applebee's restaurants located in Illinois, Indiana, Kentucky and Missouri for \$21,800,000 in cash and \$1,400,000 in assumed debt from a franchisee. The total cash payment included \$20,800,000 paid at closing, approximately \$200,000 paid as a deposit in fiscal 2002 and approximately \$800,000 paid in the second quarter of 2003. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition. The purchase price of \$23,200,000 was allocated to the fair value of property and equipment of \$7,900,000, goodwill of \$16,600,000, and other net liabilities of \$1,300,000.

The following table is comprised of actual company restaurant sales included in our consolidated financial statements for each period presented and pro forma company restaurant sales assuming the two acquisitions above occurred at the beginning of each respective period (in thousands):

|                                                  | 13 Weeks Ended   |                  |    |
|--------------------------------------------------|------------------|------------------|----|
|                                                  | June 27,<br>2004 | June 29,<br>2003 |    |
| Actual acquired company restaurant sales.....    | \$ 11,000        | \$ 6,400         | \$ |
| Pro forma acquired company restaurant sales..... | \$ 13,200        | \$ 12,000        | \$ |

In 2002, we acquired the operations and assets of 21 Applebee's restaurants located in the Washington, D.C. area from a franchisee. The purchase agreement provided for additional consideration to be paid in July 2004 if the restaurants achieved cash flows in excess of historical levels. As of June 27, 2004, we have determined that the additional payment will be approximately \$100,000 which has been recorded as goodwill in our consolidated financial statements.

### 7. Disposition

On July 20, 2003, we completed the sale of eight company restaurants in the Atlanta, Georgia market to an affiliate of an existing franchisee for

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\$8,000,000. In connection with the sale of these restaurants, we closed one restaurant in the Atlanta market in June 2003. This transaction did not have a significant impact on our net earnings for fiscal 2003. Actual company restaurant sales included in our consolidated financial statements for the nine restaurants were approximately \$4,600,000 and \$9,300,000 for the 13 weeks and 26 weeks ended June 29, 2003, respectively.

## 8. Inventory Impairment

In the second quarter of 2004, we determined that we had excess inventories of riblets that no longer met our quality standards. Accordingly, we recorded an inventory impairment of \$2,300,000 (approximately \$1,500,000 net of income taxes) in our consolidated financial statements. The portion of the riblet inventory impairment related to the company's historical usage of approximately \$500,000 was recorded in food and beverage cost and the portion related to the franchisee's historical usage of approximately \$1,800,000 was recorded in cost of other franchise income in the consolidated statements of earnings.

## 9. Impairment of Chevys Note Receivable

In 1999, we received a \$6,000,000, 8% subordinated note in connection with the sale of the Rio Bravo concept to Chevys Holdings, Inc ("Chevys") due in 2009. The note receivable balance of approximately \$8,800,000 as of June 27, 2004 and December 28, 2003, respectively, is included in other assets in our consolidated balance sheets. In June 2003, Chevys announced the sale of the majority of its restaurants. Subsequent to the announcement, we received Chevys' audited financial statements for the fiscal year ended December 31, 2002. During the fiscal quarter ended June 29, 2003, we fully impaired the principal and accrued interest of approximately \$8,800,000. A charge for the impairment of this note is included in our consolidated statements of earnings for the 13 weeks and 26 weeks ended June 29, 2003. In October 2003, Chevys Inc. filed a voluntary petition to reorganize under Chapter 11 of the U.S. Bankruptcy Code. We no longer accrue interest receivable on this note and will record future interest income on this note only upon the receipt of any related cash payments.

## 10. Goodwill and Other Intangible Assets

Changes in goodwill are summarized below (in thousands):

|                                             | June 27,<br>2004  | Dec<br>2003 |
|---------------------------------------------|-------------------|-------------|
| Carrying amount, beginning of the year..... | \$ 105,326        | \$          |
| Goodwill acquired during the period.....    | 11,018            |             |
|                                             | <u>\$ 116,344</u> | <u>\$</u>   |
|                                             | =====             | =====       |

Intangible assets subject to amortization pursuant to SFAS No. 142, "Goodwill and Other Intangible Assets," are summarized below (in thousands):

|                | June 27, 2004 |
|----------------|---------------|
|                | -----         |
| Gross Carrying | Accumulated   |

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|                                    | Amount            | Amortization      |       |
|------------------------------------|-------------------|-------------------|-------|
|                                    | -----             | -----             | ----- |
| Amortized intangible assets:       |                   |                   |       |
| Franchise interest and rights..... | \$          6,371 | \$          5,400 | \$    |
| Lease acquisition costs.....       | 4,919             | 71                |       |
|                                    | -----             | -----             | ----- |
| Total.....                         | \$         11,290 | \$          5,471 | \$    |
|                                    | =====             | =====             | ===== |

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|                                    | December 28, 2003        |                             |       |
|------------------------------------|--------------------------|-----------------------------|-------|
|                                    | -----                    | -----                       | ----- |
|                                    | Gross Carrying<br>Amount | Accumulated<br>Amortization |       |
|                                    | -----                    | -----                       | ----- |
| Amortized intangible assets:       |                          |                             |       |
| Franchise interest and rights..... | \$          6,371        | \$          5,234           | \$    |
|                                    | =====                    | =====                       | ===== |

In the second quarter of 2004, we acquired six restaurant leases for approximately \$4,900,000 in cash. The lease acquisition costs are being amortized over the next 8 to 20 years and the franchise interest and rights are being amortized over the next two to four years.

We expect annual amortization expense for all intangible assets for the next five fiscal years to range from approximately \$500,000 to \$800,000.

#### 11. Captive Insurance Subsidiary

In 2002, we formed Neighborhood Insurance, Inc., a Vermont corporation and a wholly-owned captive insurance subsidiary to provide Applebee's International, Inc. and qualified franchisees with workers' compensation and general liability insurance. Applebee's International, Inc. and covered franchisees make premium payments to the captive insurance company which pays administrative fees and insurance claims, subject to individual and aggregate maximum claim limits under the captive insurance company's reinsurance policies. Franchisee premium amounts billed by the captive insurance company are established based upon third-party actuarial estimates of settlement costs for incurred claims and administrative fees. The franchisee premiums are included in other franchise income ratably over the policy year. The related offsetting expenses are included in cost of other franchise income. Accordingly, we do not expect franchisee participation in the captive insurance company to have a material impact on our net earnings.

As of June 27, 2004, our consolidated balance sheet includes the following balances related to the captive insurance subsidiary:

- o Deferred policy acquisition costs of approximately \$1,700,000 included in other current assets related to captive insurance subsidiary.
- o Franchise premium receivables of approximately \$4,800,000 included in receivables related to captive insurance subsidiary.
- o Cash equivalent investments restricted for the payment of claims of approximately \$15,500,000 included in restricted assets related to captive insurance subsidiary.
- o Loss reserve and unearned premiums related to captive insurance

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- subsidiary of approximately \$20,800,000.
- o Other miscellaneous items, net, of approximately \$1,200,000 included in several line items in the consolidated balance sheet.

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### 12. New Accounting Pronouncement

In December 2003, the FASB issued FASB Interpretation No. ("FIN") 46R, "Consolidation of Variable Interest Entities and Interpretation of ARB No. 51." This interpretation, which replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. This interpretation is required in financial statements for periods ending after March 15, 2004 for those companies that have yet to adopt the provisions of FIN 46. We adopted FIN 46R in January 2004 and the initial adoption did not have a material impact on our consolidated financial statements.

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

#### Overview

Our results continue to be driven by the execution of integrated strategies, including improved food, promotions backed by effective advertising, meeting our guests' desires for more convenience, our focus on operations excellence and the retention of better people.

We completed the rollout of our Carside To Go(TM) program in all company restaurants where practicable in November 2003 and our franchisees will continue implementation during 2004. We expect Carside To Go(TM) to be a significant driver of sales and traffic growth in 2004.

Our revenues are generated from three primary sources:

- o Company restaurant sales (food and beverage sales)
- o Franchise royalties and fees
- o Other franchise income

Beverage sales consist of sales of alcoholic beverages, while non-alcoholic beverages are included in food sales. Franchise royalties are generally 4% of each franchise restaurant's monthly gross sales. Franchise fees typically range from \$30,000 to \$35,000 for each restaurant opened. Other franchise income includes insurance premiums from franchisee participation in our captive insurance company and revenue from information technology products and services provided to certain franchisees.

Comparable restaurant sales are based upon those restaurants open for at least 18 months and are compared from period to period.

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Certain expenses relate only to company operated restaurants. These include:

- o Food and beverage costs
- o Labor costs
- o Direct and occupancy costs
- o Pre-opening expenses

Cost of other franchise income includes the costs related to franchisee participation in our captive insurance company and costs related to information technology products and services provided to certain franchisees. In addition, cost of other franchise income in fiscal 2004 includes the franchisee portion of the riblet inventory impairment (see Note 8).

Other expenses, such as general and administrative and amortization expenses, relate to both company operated restaurants and franchise operations.

We operate on a 52 or 53 week fiscal year ending on the last Sunday in December. Our fiscal quarters ended June 27, 2004 and June 29, 2003 each contained 13 weeks and are referred to hereafter as the "2004 quarter" and the "2003 quarter," respectively. Our 26 week periods ended June 27, 2004 and June 29, 2003 are referred to hereafter as the "2004 year-to-date period" and the "2003 year-to-date period," respectively.

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In 2002, we formed Neighborhood Insurance, Inc., a Vermont corporation and a wholly-owned captive insurance subsidiary to provide Applebee's International, Inc. and qualified franchisees with workers' compensation and general liability insurance. Applebee's International, Inc. and covered franchisees make premium payments to the captive insurance company which pays administrative fees and insurance claims, subject to individual and aggregate maximum claim limits under the captive insurance company's reinsurance policies. Franchisee premium amounts billed by the captive insurance company are established based upon third-party actuarial estimates of settlement costs for incurred claims and administrative fees. The franchisee premiums are included in other franchise income ratably over the policy year. The related offsetting expenses are included in cost of other franchise income. Accordingly, we do not expect franchisee participation in the captive insurance company to have a material impact on our net earnings.

As of June 27, 2004, our consolidated balance sheet includes the following balances related to the captive insurance subsidiary:

- o Deferred policy acquisition costs of approximately \$1,700,000 included in other current assets related to captive insurance subsidiary.
- o Franchise premium receivables of approximately \$4,800,000 included in receivables related to captive insurance subsidiary.
- o Cash equivalent investments restricted for the payment of claims of approximately \$15,500,000 included in restricted assets related to captive insurance subsidiary.
- o Loss reserve and unearned premiums related to captive insurance subsidiary of approximately \$20,800,000.
- o Other miscellaneous items, net, of approximately \$1,200,000 included in several line items in the consolidated balance sheet.

### Application of Critical Accounting Policies

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our consolidated financial statements, which were prepared in accordance with accounting principles generally accepted in the

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United States of America. These principles require us to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and notes thereto. Actual results may differ from these estimates, and such differences may be material to our consolidated financial statements. We believe that the following significant accounting policies involve a higher degree of judgment or complexity.

**Franchise revenues:** Franchise revenues consist of franchise royalties, franchise fees and other franchise income. We recognize royalties on a franchisee's sales in the period in which the sales are reported to have occurred. We also receive a franchise fee for each restaurant that a franchisee opens. The recognition of franchise fees is deferred until we have performed substantially all of our related obligations as franchisor, typically when the restaurant opens. Other franchise income includes insurance premiums from franchisee participation in our captive insurance company and revenue from information technology products and services provided to certain franchisees. Income from franchise premiums and information technology services is recognized ratably over the related contract period. Income from information technology products is recognized when the products are installed at the restaurant.

**Inventory valuation:** We state inventories at the lower of cost, using the first-in, first-out method, or market. Market is determined based upon the estimated net realizable value.

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We purchase and maintain inventories of certain specialty products to assure sufficient supplies to the system. We review and make quality control inspections of our inventories to determine obsolescence on an ongoing basis. These reviews require management to make certain estimates and judgments.

**Property and equipment:** Property and equipment are depreciated on a straight-line basis over the estimated useful lives of the assets. The useful lives of the assets are based upon management's expectations. We periodically review the assets for changes in circumstances which may impact their useful lives.

**Impairment of long-lived assets:** We periodically review property and equipment for impairment on a restaurant by restaurant basis using historical cash flows as well as current estimates of future cash flows and/or appraisals. This assessment process requires the use of estimates and assumptions which are subject to a significant degree of judgment. In addition, we periodically assess the recoverability of goodwill and other intangible assets, which requires us to make assumptions regarding the future cash flows and other factors to determine the fair value of the assets. If these assumptions change in the future, we may be required to record impairment charges for these assets.

**Legal and insurance reserves:** We are periodically involved in various legal actions. We are required to assess the probability of any adverse judgments as well as the potential range of loss. We determine the required accruals after a review of the facts of each legal action.

We use estimates in the determination of the appropriate liabilities for general liability, workers' compensation and health insurance. The estimated liability is established based upon historical claims data and third-party actuarial estimates of settlement costs for incurred claims. Unanticipated changes in these factors may require us to revise our estimates.

**Employee incentive compensation plans:** We have various long-term employee

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incentive compensation plans which require us to make estimates to determine our liability based upon projected performance of plan criteria. If actual performance against the criteria differs from our estimates in the future, we will be required to adjust our liability accordingly.

**Receivables:** We continually assess the collectibility of our franchise receivables. We establish our allowance for bad debts based on several factors, including historical collection experience, the current economic environment and other specific information available to us at the time. The allowance for bad debts may change in the future due to changes in the factors above or other developments.

We periodically reassess our assumptions and judgments and make adjustments when significant facts and circumstances dictate. A change in any of the above estimates could impact our consolidated statements of earnings and the related asset or liability recorded in the consolidated balance sheets would be adjusted accordingly. Historically, actual results have not been materially different than the estimates that are described above.

### Acquisitions

On April 26, 2004, we completed our acquisition of the operations and assets of 10 Applebee's restaurants located in Southern California for approximately \$13,700,000 in cash. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition. The purchase price was allocated to the fair value of property and equipment of \$2,500,000, goodwill of \$10,800,000 and other net assets of approximately \$400,000. We do not expect this transaction to have a significant impact on our net earnings for fiscal 2004.

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On March 24, 2003, we acquired the operations and assets of 11 Applebee's restaurants located in Illinois, Indiana, Kentucky and Missouri for \$21,800,000 in cash and \$1,400,000 in assumed debt from a franchisee. The total cash payment included \$20,800,000 paid at closing, approximately \$200,000 paid as a deposit in fiscal 2002 and approximately \$800,000 paid in the second quarter of 2003. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition. The purchase price of \$23,200,000 was allocated to the fair value of property and equipment of \$7,900,000, goodwill of \$16,600,000, and other net liabilities of \$1,300,000.

The following table is comprised of actual company restaurant sales included in our consolidated financial statements for each period presented and pro forma company restaurant sales assuming the two acquisitions above occurred at the beginning of each respective period (in thousands):

|                                                  | 13 Weeks Ended   |                  |    |
|--------------------------------------------------|------------------|------------------|----|
|                                                  | June 27,<br>2004 | June 29,<br>2003 |    |
| Actual acquired company restaurant sales.....    | \$ 11,000        | \$ 6,400         | \$ |
| Pro forma acquired company restaurant sales..... | \$ 13,200        | \$ 12,000        | \$ |

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In 2002, we acquired the operations and assets of 21 Applebee's restaurants located in the Washington, D.C. area from a franchisee. The purchase agreement provided for additional consideration to be paid in July 2004 if the restaurants achieved cash flows in excess of historical levels. As of June 27, 2004, we have determined that the amount of the additional payment will be approximately \$100,000 which has been recorded as goodwill in our consolidated financial statements.

### Disposition

On July 20, 2003, we completed the sale of eight company restaurants in the Atlanta, Georgia market to an affiliate of an existing franchisee for \$8,000,000. In connection with the sale of these restaurants, we closed one restaurant in the Atlanta market in June 2003. This transaction did not have a significant impact on our net earnings for fiscal 2003. Actual company restaurant sales included in our consolidated financial statements for the nine restaurants were approximately \$4,600,000 and \$9,300,000 for the 13 weeks and the 26 weeks ended June 29, 2003, respectively.

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### Results of Operations

The following table contains information derived from our consolidated statements of earnings expressed as a percentage of total operating revenues, except where otherwise noted. Percentages may not add due to rounding.

|                                                                                 | 13 Weeks Ended   |                  |
|---------------------------------------------------------------------------------|------------------|------------------|
|                                                                                 | June 27,<br>2004 | June 29,<br>2003 |
| Revenues:                                                                       |                  |                  |
| Company restaurant sales.....                                                   | 87.9%            | 87.8%            |
| Franchise royalties and fees.....                                               | 10.9             | 10.9             |
| Other franchise income.....                                                     | 1.2              | 1.3              |
| Total operating revenues.....                                                   | 100.0%           | 100.0%           |
| Cost of sales (as a percentage of company restaurant sales):                    |                  |                  |
| Food and beverage.....                                                          | 26.9%            | 25.9%            |
| Labor.....                                                                      | 32.7             | 32.6             |
| Direct and occupancy.....                                                       | 24.3             | 24.7             |
| Pre-opening expense.....                                                        | 0.2              | 0.2              |
| Total cost of sales.....                                                        | 84.1%            | 83.4%            |
| Cost of other franchise income (as a percentage of other franchise income)..... | 148.1%           | 97.1%            |
| General and administrative expenses.....                                        | 8.8              | 9.1              |
| Amortization of intangible assets.....                                          | --               | --               |
| Loss on disposition of restaurants and equipment.....                           | 0.2              | 0.3              |

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|                                           |       |       |
|-------------------------------------------|-------|-------|
| Operating earnings.....                   | 15.2  | 16.1  |
| Other income (expense):                   |       |       |
| Investment income.....                    | --    | 0.2   |
| Interest expense.....                     | (0.1) | (0.2) |
| Impairment of Chevys note receivable..... | --    | (3.5) |
| Other income.....                         | 0.3   | --    |
| Total other income (expense).....         | 0.2   | (3.5) |
| Earnings before income taxes.....         | 15.4  | 12.5  |
| Income taxes.....                         | 5.4   | 4.5   |
| Net earnings.....                         | 10.0% | 8.1%  |

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The following table sets forth certain unaudited financial information and other restaurant data relating to company and franchise restaurants, as reported to us by franchisees:

|                                               | 13 Weeks Ended   |                  |         |
|-----------------------------------------------|------------------|------------------|---------|
|                                               | June 27,<br>2004 | June 29,<br>2003 | June 20 |
| Number of restaurants:                        |                  |                  |         |
| Company:                                      |                  |                  |         |
| Beginning of period.....                      | 391              | 371              |         |
| Restaurant openings.....                      | 4                | 4                |         |
| Restaurants closed.....                       | --               | (2)              |         |
| Restaurants acquired from franchisees.....    | 10               | --               |         |
| End of period.....                            | 405              | 373              |         |
| Franchise:                                    |                  |                  |         |
| Beginning of period.....                      | 1,212            | 1,142            | 1       |
| Restaurant openings.....                      | 8                | 13               |         |
| Restaurants closed.....                       | (3)              | --               |         |
| Restaurants acquired from franchisees.....    | (10)             | --               |         |
| End of period.....                            | 1,207            | 1,155            | 1       |
| Total:                                        |                  |                  |         |
| Beginning of period.....                      | 1,603            | 1,513            | 1       |
| Restaurant openings.....                      | 12               | 17               |         |
| Restaurants closed.....                       | (3)              | (2)              |         |
| End of period.....                            | 1,612            | 1,528            | 1       |
| Weighted average weekly sales per restaurant: |                  |                  |         |
| Company.....                                  | \$ 47,758        | \$ 45,402        | \$ 48   |
| Franchise.....                                | \$ 48,759        | \$ 45,940        | \$ 48   |

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|                                           |            |            |            |
|-------------------------------------------|------------|------------|------------|
| Total.....                                | \$ 48,510  | \$ 45,807  | \$ 48,510  |
| Change in comparable restaurant sales:(1) |            |            |            |
| Company.....                              | 5.5%       | 5.1%       |            |
| Franchise.....                            | 6.5%       | 3.2%       |            |
| Total.....                                | 6.3%       | 3.6%       |            |
| Total operating revenues (in thousands):  |            |            |            |
| Company restaurant sales.....             | \$ 247,769 | \$ 220,107 | \$ 491,329 |
| Franchise royalties and fees(2).....      | 30,779     | 27,331     | 61,551     |
| Other franchise income(3).....            | 3,399      | 3,268      | 6,667      |
|                                           | -----      | -----      | -----      |
| Total.....                                | \$ 281,947 | \$ 250,706 | \$ 559,547 |
|                                           | =====      | =====      | =====      |

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Company Restaurant Sales. Total company restaurant sales increased \$27,662,000 (13%) from \$220,107,000 in the 2003 quarter to \$247,769,000 in the 2004 quarter and increased \$62,812,000 (15%) from \$428,517,000 in the 2003 year-to-date period to \$491,329,000 in the 2004 year-to-date period. Company restaurant openings contributed approximately 8% of the increase in total company restaurant sales in both the 2004 quarter and the 2004 year-to-date period. Weighted average weekly sales contributed approximately 5% and 7% of the total company sales increase in the 2004 quarter and 2004 year-to-date period, respectively. Both periods were also favorably impacted by the acquisition of 10 restaurants in Southern California in April 2004 which was partially offset by the impact of the sale of 8 restaurants in the Atlanta, Georgia market in July 2003. In addition, the March 2003 acquisition of 11 restaurants in Illinois, Indiana, Kentucky and Missouri contributed approximately 1% of the total sales increase in the 2004 year-to-date period.

Comparable restaurant sales at company restaurants increased by 5.5% and 7.0% in the 2004 quarter and the 2004 year-to-date period, respectively. Weighted average weekly sales at company restaurants increased 5.2% from \$45,402 in the 2003 quarter to \$47,758 in the 2004 quarter and increased 6.7% from \$45,041 in the 2003 year-to-date period to \$48,075 in the 2004 year-to-date period. These increases were due primarily to increases in guest traffic and in the average guest check resulting from our food promotions. In addition, a portion of the increase resulted from the implementation of our Carside To Go(TM) initiative and menu price increases of approximately 1.5% in fiscal 2004. Carside To Go(TM) sales mix increased from 6.8% of company restaurant sales in the 2003 quarter to 9.4% of company restaurant sales in the 2004 quarter.

Franchise Royalties and Fees. Franchise royalties and fees increased \$3,448,000 (13%) from \$27,331,000 in the 2003 quarter to \$30,779,000 in the 2004 quarter and increased \$7,057,000 (13%) from \$54,494,000 in the 2003 year-to-date period to \$61,551,000 in the 2004 year-to-date period. These increases were due primarily to the increased number of franchise restaurants operating during the 2004 quarter and 2004 year-to-date period as compared to the same periods in 2003 and increases in comparable restaurant sales. Weighted average weekly sales at franchise restaurants increased 6.1% and 6.7% in the 2004 quarter and 2004 year-to-date period, respectively, and franchise comparable restaurant sales increased 6.5% and 7.2% in the 2004 quarter and 2004 year-to-date period, respectively.

Other Franchise Income. Other franchise income increased \$131,000 (4%) from

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\$3,268,000 in the 2003 quarter to \$3,399,000 in the 2004 quarter and increased \$605,000 (10%) from \$5,909,000 in the 2003 year-to-date period to \$6,514,000 in the 2004 year-to-date period due primarily to revenues recognized related to the franchise premium amounts billed by the captive insurance company. Franchise premiums are included in other franchise income ratably over the policy year.

Cost of Company Restaurant Sales. Food and beverage costs increased from 25.9% in the 2003 quarter to 26.9% in the 2004 quarter and increased from 26.1% in the 2003 year-to-date period to 26.5% in the 2004 year-to-date period. The increases in both the 2004 quarter and 2004 year-to-date period were due primarily to higher commodity costs, higher food costs related to our menu promotions and the company portion of the June 2004 impairment of approximately \$500,000 for excess riblet inventories which no longer met our quality standards. These increases were partially offset by menu price increases in both the 2004 quarter and the 2004 year-to-date period.

Labor costs increased from 32.6% in the 2003 quarter to 32.7% in the 2004 quarter and were 32.7% in both the 2003 year-to-date period and the 2004 year-to-date period. Both periods were impacted by higher costs related to the

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addition of dedicated Carside To Go(TM) hourly labor at most of our restaurants beginning in the second half of 2003, higher preparation time and training costs related to the May 2004 rollout of our new Weight Watchers menu and higher workers' compensation costs. These higher costs were offset in both periods by lower management and hourly costs due to higher sales volumes at company restaurants and lower management incentive compensation.

Direct and occupancy costs decreased from 24.7% in the 2003 quarter and 24.5% in the 2003 year-to-date period to 24.3% in both the 2004 quarter the 2004 year-to-date period due to higher sales volumes at company restaurants which resulted in favorable depreciation expense, rent expense and repairs and maintenance expense, as a percentage of sales, due to their relatively fixed nature. The decrease in the 2004 quarter was also due to lower property and liability insurance expense. Decreases in both periods were partially offset by higher packaging costs as a result of increased Carside To Go(TM) sales volumes. The 2004 year-to-date period was also unfavorably impacted by higher advertising costs, as a percentage of sales, due primarily to Carside To Go(TM) advertising in company markets.

Cost of Other Franchise Income. Cost of other franchise income increased \$1,862,000 from \$3,173,000 in the 2003 quarter to \$5,035,000 in the 2004 quarter and increased \$2,299,000 from \$5,673,000 in the 2003 year-to-date period to \$7,972,000 in the 2004 year-to-date due primarily to the franchisee portion of the June 2004 impairment of approximately \$1,800,000 for excess riblet inventories which no longer met our quality standards.

General and Administrative Expenses. General and administrative expenses decreased from 9.1% in the 2003 quarter and 9.3% in the 2003 year-to-date period to 8.8% in the 2004 quarter and 9.0% in the 2004 year-to-date period. General and administrative expenses were lower in both the 2004 quarter and 2004 year-to-date period due to the absorption of general and administrative expenses over a larger revenue base which were partially offset by higher compensation expense due to staffing levels.

Impairment of Chevys Note Receivable. In June 2003, Chevys announced the sale of the majority of its restaurants. Subsequent to the announcement, we received Chevys' audited financial statements for the fiscal year ended December 31,

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2002. During the fiscal quarter ended June 29, 2003, we fully impaired the principal and accrued interest of approximately \$8,800,000. In October 2003, Chevys Inc. filed a voluntary petition to reorganize under Chapter 11 of the U.S. Bankruptcy Code.

**Income Taxes.** The effective income tax rate, as a percentage of earnings before income taxes, decreased from 35.8% in the 2003 quarter and 36.0% in the 2003 year-to-date period to 35.0% in both the 2004 quarter and the 2004 year-to-date period due to a reduction in state and local income taxes.

### Liquidity and Capital Resources

Our need for capital historically has resulted from the construction and acquisition of restaurants, the repurchase of our common shares and investment in information technology systems. In the past, we have obtained capital through public stock offerings, debt financing, and our ongoing operations. Cash flows from our ongoing operations include cash generated from company and franchise operations, credit from trade suppliers, real estate lease financing, and landlord contributions to leasehold improvements. We have also used our common stock as consideration in the acquisition of restaurants. In addition, we have assumed debt or issued new debt in connection with certain mergers and acquisitions.

Capital expenditures were \$82,562,000 in 2003 (excluding the acquisition of 11 restaurants) and \$36,543,000 in the 2004 year-to-date period (excluding the acquisition of 10 restaurants and lease acquisition costs). We currently expect to open at least 32 company restaurants, and capital expenditures, excluding acquisitions, are expected to be between \$95,000,000 and \$105,000,000 in 2004.

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These expenditures will primarily be for the development of new restaurants, refurbishment and capital replacement for existing restaurants, the enhancement of information systems and lease acquisition costs. Because we expect to continue to purchase a portion of our sites, the amount of actual capital expenditures will be dependent upon, among other things, the proportion of leased versus owned properties. In addition, if we open more restaurants than we currently anticipate or acquire additional restaurants, our capital requirements will increase accordingly.

On April 26, 2004, we completed our acquisition of the operations and assets of 10 Applebee's restaurants located in Southern California for approximately \$13,700,000 in cash. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition. In addition, we acquired six restaurant leases for approximately \$4,900,000 in cash in the 2004 quarter.

On July 20, 2003, we completed the sale of eight company restaurants in the Atlanta, Georgia market to an affiliate of an existing franchisee for \$8,000,000. In connection with the sale of these restaurants, we closed one restaurant in the Atlanta market in June 2003.

On March 24, 2003, we acquired the operations and assets of 11 Applebee's restaurants located in Illinois, Indiana, Kentucky and Missouri for \$21,800,000 in cash and \$1,400,000 in assumed debt from a franchisee. The total cash payment included \$20,800,000 paid at closing, approximately \$200,000 paid as a deposit in fiscal 2002 and approximately \$800,000 paid in the second quarter of 2003. Our financial statements reflect the results of operations for these restaurants subsequent to the date of acquisition.

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Our bank credit agreement, as amended, expires in November of 2005 and provides for a \$150,000,000 unsecured revolving credit facility, of which \$25,000,000 may be used for the issuance of letters of credit. The facility is subject to various covenants and restrictions which, among other things, require the maintenance of stipulated fixed charge, leverage and indebtedness to capitalization ratios, as defined, and limit additional indebtedness and capital expenditures in excess of specified amounts. Cash dividends are limited to \$10,000,000 annually. The facility is subject to standard other terms, conditions, covenants, and fees. We are currently in compliance with the covenants contained in our credit agreement. As of June 27, 2004, we had borrowings of \$38,000,000 and had standby letters of credit of approximately \$11,920,000 outstanding under our revolving credit facility.

Our Board of Directors authorized repurchases of our common stock of up to \$75,000,000 and \$80,000,000 in 2002 and 2003, respectively. As of December 28, 2003, we had \$99,800,000 remaining on our authorizations. During the 2004 year-to-date period, we repurchased 2,097,450 shares of our common stock at an average price of \$25.38 for an aggregate cost of \$53,200,000. As of June 27, 2004, we had \$46,500,000 remaining under our repurchase authorization.

As of June 27, 2004, our liquid assets totaled \$15,170,000. These assets consisted of cash and cash equivalents in the amount of \$14,890,000 and short-term investments in the amount of \$280,000. The working capital deficit decreased from \$62,710,000 as of December 28, 2003 to \$56,121,000 as of June 27, 2004. This decrease was due primarily to the redemption of gift cards in 2004 sold in 2003, the payment of accrued dividends and bonuses and increases in inventories and receivables and was partially offset by increases in accrued income taxes and loss reserve and unearned premiums related to the captive insurance subsidiary.

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We believe that our liquid assets and cash generated from operations, combined with borrowings available under our credit facilities, will provide sufficient funds for our operating, capital and other requirements for the foreseeable future.

The following table shows our debt amortization schedule, future capital lease commitments (including principal and interest payments), future operating lease commitments and future purchase obligations as of June 27, 2004 (in thousands):

| Certain<br>Contractual Obligations                           | Payments due by period |                     |              |
|--------------------------------------------------------------|------------------------|---------------------|--------------|
|                                                              | Total                  | Less than 1<br>year | 1-3<br>Years |
| Long-term Debt (excluding capital<br>lease obligations)..... | \$ 39,612              | \$ 127              | \$ 38,249    |
| Capital Lease Obligations.....                               | 9,474                  | 754                 | 1,588        |
| Operating Leases.....                                        | 245,675                | 21,441              | 41,149       |
| Purchase Obligations - Company(1).....                       | 172,830                | 116,230             | 36,834       |
| Purchase Obligations - Franchise(2).....                     | 385,240                | 254,780             | 97,505       |

(1) The amounts for company purchase obligations include commitments for food items and supplies, severance and employment agreements, and other

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miscellaneous commitments.

- (2) The amounts for franchise purchase obligations include commitments for food items and supplies made by Applebee's International, Inc. for our franchisees. Applebee's International, Inc. contracts with certain suppliers to ensure competitive pricing. These amounts will only be payable by Applebee's International, Inc. if our franchisees do not meet certain minimum contractual requirements.

### Other Contractual Obligations

We have outstanding lease guarantees of approximately \$19,800,000 as of June 27, 2004 (see Note 3). We have not recorded a liability for these guarantees as of June 27, 2004 or December 28, 2003.

We have severance and employment agreements with certain officers and other senior executives providing for severance payments to be made in the event the employee resigns or is terminated related to a change in control. The agreements define the circumstances which will constitute a change in control. If the severance payments had been due as of June 27, 2004, we would have been required to make payments totaling approximately \$12,200,000. In addition, we have severance and employment agreements with certain officers which contain severance provisions not related to a change in control. Those provisions would have required aggregate payments of approximately \$7,200,000 if such officers had been terminated as of June 27, 2004.

In November 2003, we arranged for a financing company to provide up to \$75,000,000 to qualified franchisees for short-term loans to fund remodel investments. Under the terms of this financing program, we will provide a limited guarantee pool for the loans advanced during the three-year period ending December 2006. There was one loan outstanding for approximately \$400,000 under this program as of June 27, 2004. The fair value of our guarantee was immaterial and accordingly, we have not recorded a liability as of June 27, 2004.

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### Inflation

Substantial increases in costs and expenses could impact our operating results to the extent such increases cannot be passed along to customers. In particular, increases in food, supplies, labor and operating expenses could have a significant impact on our operating results. We do not believe that inflation has materially affected our operating results during the past three years.

A majority of our employees are paid hourly rates related to federal and state minimum wage laws and various laws that allow for credits to that wage. The Federal government continues to consider an increase in the minimum wage. Several state governments have increased the minimum wage and other state governments are also considering an increased minimum wage. In the past, we have been able to pass along cost increases to customers through food and beverage price increases, and we will attempt to do so in the future. We cannot guarantee, however, that all future cost increases can be reflected in our prices or that increased prices will be absorbed by customers without at least somewhat diminishing customer spending in our restaurants.

### New Accounting Pronouncement

In December 2003, the FASB issued FASB Interpretation No. ("FIN") 46R,

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"Consolidation of Variable Interest Entities and Interpretation of ARB No. 51." This interpretation, which replaces FASB Interpretation No. 46, "Consolidation of Variable Interest Entities," clarifies the application of Accounting Research Bulletin No. 51, "Consolidated Financial Statements," to certain entities in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. This interpretation is required in financial statements for periods ending after March 15, 2004 for those companies that have yet to adopt the provisions of FIN 46. We adopted FIN 46R in January 2004 and the initial adoption did not have a material impact on our consolidated financial statements.

### Forward-Looking Statements

The statements contained in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section regarding restaurant development, capital expenditures and financial commitments are forward-looking and based on current expectations. There are several risks and uncertainties that could cause actual results to differ materially from those described. These risks include but are not limited to our ability and the ability of our franchisees to open and operate additional restaurants profitably, the ability of our franchisees to obtain financing, the continued growth of our franchisees, our ability to attract and retain qualified franchisees, the impact of intense competition in the casual dining segment of the restaurant industry, and our ability to control restaurant operating costs which are impacted by market changes, minimum wage and other employment laws, food costs and inflation. For a more detailed discussion of the principal factors that could cause actual results to be materially different, you should read our current report on Form 8-K which we filed with the Securities and Exchange Commission on February 11, 2004. We disclaim any obligation to update forward-looking statements.

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### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from fluctuations in interest rates and changes in commodity prices. Our revolving credit facility bears interest at either the bank's prime rate or LIBOR plus 0.625%, at our option. As of June 27, 2004, the total amount of debt subject to interest rate fluctuations was \$38,000,000 which was outstanding on our revolving credit facility. A 1% change in interest rates would result in an increase or decrease in interest expense of \$380,000 per year. We may from time to time enter into interest rate swap agreements to manage the impact of interest rate changes on our earnings. Many of the food products we purchase are subject to price volatility due to factors that are outside of our control such as available supply, weather and seasonality. As part of our strategy to moderate this volatility, we have entered into fixed price purchase commitments.

### Item 4. Controls and Procedures

As of June 27, 2004, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). Based on this evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures were effective. During our most recent fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings

We are involved in various legal actions which include, without limitation, employment law related matters, dram shop claims, personal injury claims and other such normal restaurant operational matters. In each instance, we believe that we have meritorious defenses to the allegations made and we are vigorously defending these claims.

While the resolution of the matters described above may have an impact on our financial results for the period in which they are resolved, we believe that the ultimate disposition of these matters will not, individually or in the aggregate, have a material adverse effect upon our business or consolidated financial statements.

## Item 2. Changes in Securities and Use of Proceeds

## (e) Issuer Purchases of Equity Securities.

| Purchases of Equity Securities(1) (2) |                                  |                              |                                                                                  |                                                                                      |
|---------------------------------------|----------------------------------|------------------------------|----------------------------------------------------------------------------------|--------------------------------------------------------------------------------------|
|                                       | (a)                              | (b)                          | (c)                                                                              | (d)                                                                                  |
| 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 Shares that May be Purchased Under the Plan or Program (in thousands) |
| March 29, 2004 through April 27, 2004 | 3,499 (3)                        | \$28.39                      | --                                                                               | \$67,71                                                                              |
| April 28, 2004 through May 27, 2004   | 814,500                          | \$26.01                      | 814,500                                                                          | \$46,53                                                                              |
| May 28, 2004 through June 27, 2004    | --                               | --                           | --                                                                               | \$46,53                                                                              |
| Total                                 | 817,999                          |                              | 814,500                                                                          |                                                                                      |

(1) In May 2002, our Board of Directors authorized a repurchase of up to \$75,000,000 of our common stock through May 2005. In December 2003, our Board of Directors authorized an additional repurchase of up to \$80,000,000 of our common stock. The May 2002 authorization limit was met in January 2004. The December 2003 authorization has no expiration date.

(2) All references to the number of shares have been restated to reflect a three-for-two stock split, effected as a 50% stock dividend, paid on June 15, 2004.

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- (3) Represents shares received as partial payment for shares issued under stock option plans.

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### Item 4. Submission of Matters to a Vote of Security Holders

Our annual meeting of stockholders was held on May 13, 2004. The stockholders voted on the following matters:

- Proposal I. Elect Jack Helms, Lloyd Hill, Burton Sack, Michael Volkema and Steven Lumpkin as Directors.
- Proposal II. Approve the Applebee's International, Inc. Amended and Restated 1995 Equity Incentive Plan.
- Proposal III. Approve the Executive Nonqualified Stock Purchase Plan
- Proposal IV. Ratify Deloitte & Touche LLP as our independent auditors for the 2004 fiscal year.
- Proposal V. Act on a Shareholder Proposal to require us to issue a report relating to genetically engineered ingredients.

The results of the voting were as follows:

| Proposal    | Affirmative<br>Votes | Negative/<br>Withheld<br>Votes | Abstentions |
|-------------|----------------------|--------------------------------|-------------|
| I (Helms)   | 48,558,417           | 1,572,327                      | --          |
| I (Hill)    | 48,635,185           | 1,495,559                      | --          |
| I (Sack)    | 48,654,681           | 1,476,063                      | --          |
| I (Volkema) | 48,851,107           | 1,279,637                      | --          |
| I (Lumpkin) | 48,361,854           | 1,768,890                      | --          |
| II          | 26,778,025           | 15,673,253                     | 860,428     |
| III         | 30,704,447           | 11,734,261                     | 872,998     |
| IV          | 47,712,325           | 1,605,215                      | 813,203     |
| V           | 2,188,554            | 37,834,824                     | 3,288,326   |

Proposals I, II, III and IV received the required affirmative votes and were affirmatively adopted by the Stockholders. Proposal V did not receive the required affirmative votes.

### Item 6. Exhibits and Reports on Form 8-K

- (a) The Exhibits listed on the accompanying Exhibit Index are filed as part of this report.
- (b) We filed a report on Form 8-K on April 2, 2004 announcing the addition of a new executive officer.

We furnished a report on Form 8-K on April 23, 2004 announcing the

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webcast of our first quarter earnings conference call over the Internet.

We furnished a report on Form 8-K on April 28, 2004 reporting first quarter diluted earnings per share.

We filed a report on Form 8-K on May 13, 2004 announcing a three-for-two stock split.

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We filed a report on Form 8-K on May 14, 2004 announcing Mr. Volkema's election to the Board of Directors.

We filed a report on Form 8-K on May 18, 2004 announcing the temporary suspension of trading under an employee benefit plan.

We filed a report on Form 8-K on May 24, 2004 reporting May comparable sales.

We furnished a report on Form 8-K on June 2, 2004 announcing our presentation at the Piper Jaffray Consumer Conference.

We furnished a report on Form 8-K on June 10, 2004 announcing our presentation at two Investment Conferences in June.

### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

APPLEBEE'S INTERNATIONAL, INC.  
(Registrant)

Date: July 28, 2004  
-----

By: /s/ Lloyd L. Hill  
-----  
Lloyd L. Hill  
Chairman and Chief Executive Officer  
(principal executive officer)

Date: July 28, 2004  
-----

By: /s/ Steven K. Lumpkin  
-----  
Steven K. Lumpkin  
Executive Vice President and  
Chief Financial Officer  
(principal financial officer)

Date: July 28, 2004  
-----

By: /s/ Beverly O. Elving  
-----  
Beverly O. Elving  
Vice President, Accounting  
(principal accounting officer)

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APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES  
EXHIBIT INDEX

| Exhibit<br>Number | Description of Exhibit                                                                                                                                                                               |
|-------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1              | Amended and Restated 1995 Equity Incentive Plan                                                                                                                                                      |
| 10.2              | Executive Nonqualified Stock Purchase Plan                                                                                                                                                           |
| 10.3              | New Form of Indemnification Agreement with all Officers and Directors                                                                                                                                |
| 10.4              | Executive Retirement Plan (incorporated by reference to Exhibit 10.1 of the Registrant's Quarterly Report on Form 10-Q for the fiscal quarter ended March 28, 2004) and schedules of parties thereto |
| 31.1              | Certification of Chairman and Chief Executive Officer Pursuant to SEC Rule 13a-14(a)                                                                                                                 |
| 31.2              | Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14(a)                                                                                                                              |
| 32.1              | Certification of Chairman and Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350                                                                                 |

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