



The Second Cup Ltd.

Unaudited Condensed Interim Financial Statements
For the 13 and 39 weeks ended September 24, 2016 and September 26, 2015

Notice to Reader

The management of The Second Cup Ltd. (“Second Cup” or the “Company”) is responsible for the preparation of the accompanying condensed interim financial statements. The condensed interim financial statements have been prepared in accordance with International Financial Reporting Standards and are considered by management to present fairly the financial position, financial performance and cash flows of Second Cup.

These condensed interim financial statements have not been reviewed by an auditor. These condensed interim financial statements are unaudited and include all adjustments, consisting of normal and recurring items that management considers necessary for a fair presentation of the financial position, financial performance and cash flows.

(Signed)

Alix Box
President and Chief Executive Officer, The Second Cup Ltd.

(Signed)

Barbara Mallon
Chief Financial Officer, The Second Cup Ltd.

October 27, 2016

The Second Cup Ltd.

Condensed Interim Statements of Financial Position (Unaudited, expressed in thousands of Canadian dollars)

| | September 24, 2016 | December 26, 2015 |
|---|--------------------|-------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 1,960 | \$ 3,080 |
| Restricted cash (note 12) | 1,512 | 840 |
| Trade and other receivables | 2,191 | 3,434 |
| Notes and leases receivable | 127 | 120 |
| Inventories | 252 | 229 |
| Prepaid expenses and other assets | 223 | 427 |
| Income tax recoverable | 29 | 687 |
| | <u>6,294</u> | <u>8,817</u> |
| Non-current assets | | |
| Notes and leases receivable | 171 | 268 |
| Property and equipment | 3,753 | 4,761 |
| Intangible assets | 32,594 | 32,639 |
| | <u>36,518</u> | <u>37,668</u> |
| Total assets | <u>\$ 42,812</u> | <u>\$ 46,485</u> |
| LIABILITIES | | |
| Current liabilities | | |
| Accounts payable and accrued liabilities | \$ 4,429 | \$ 5,360 |
| Provisions | 1,284 | 1,655 |
| Other liabilities | 315 | 534 |
| Gift card liability | 2,831 | 3,554 |
| Deposits from franchisees | 1002 | 701 |
| Current portion of long-term debt (note 6) | 5,996 | - |
| | <u>15,857</u> | <u>11,804</u> |
| Non-current liabilities | | |
| Provisions | 719 | 982 |
| Other liabilities | 224 | 314 |
| Long-term debt (note 6) | - | 5,977 |
| Deferred income taxes | 3,158 | 3,481 |
| | <u>4,101</u> | <u>10,754</u> |
| Total liabilities | <u>19,958</u> | <u>22,558</u> |
| SHAREHOLDERS' EQUITY | <u>22,854</u> | <u>23,927</u> |
| Total liabilities and shareholders' equity | <u>\$ 42,812</u> | <u>\$ 46,485</u> |

Contingencies, commitments and guarantees (note 13).

See accompanying notes to the unaudited condensed interim financial statements.

Approved by the Directors on October 27, 2016

Michael Bregman, Director

Rael Merson, Director

The Second Cup Ltd.

Condensed Interim Statements of Loss and Comprehensive Loss

(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

| | 13 weeks ended | | 39 weeks ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Revenue (note 7) | | | | |
| Company-owned cafés and product sales | \$ 3,629 | \$ 5,703 | \$ 11,453 | \$ 16,576 |
| Franchise revenue | 4,027 | 3,567 | 11,398 | 11,129 |
| | <u>7,656</u> | <u>9,270</u> | <u>22,851</u> | <u>27,705</u> |
| Operating costs and expenses (note 8) | | | | |
| Company-owned cafés and cost of product sales | 3,857 | 5,841 | 12,272 | 16,687 |
| Franchise | 1,888 | 3,104 | 6,097 | 7,009 |
| General and administrative | 1,403 | 1,203 | 4,276 | 4,222 |
| Loss (gain) on disposal of assets | 151 | 45 | 309 | (43) |
| Depreciation and amortization | 382 | 387 | 1,183 | 1,078 |
| | <u>7,681</u> | <u>10,580</u> | <u>24,137</u> | <u>28,953</u> |
| Income (loss) from operations | <u>(25)</u> | <u>(1,310)</u> | <u>(1,286)</u> | <u>(1,248)</u> |
| Interest and financing (note 9) | 62 | 137 | 159 | 385 |
| | <u>(87)</u> | <u>(1,447)</u> | <u>(1,445)</u> | <u>(1,633)</u> |
| Loss before income taxes | <u>(87)</u> | <u>(1,447)</u> | <u>(1,445)</u> | <u>(1,633)</u> |
| Recovery of income taxes | (12) | (348) | (323) | (386) |
| | <u>(75)</u> | <u>(1,099)</u> | <u>(1,122)</u> | <u>(1,247)</u> |
| Net loss and comprehensive loss for the period | <u>(75)</u> | <u>(1,099)</u> | <u>(1,122)</u> | <u>(1,247)</u> |
| Basic and diluted loss per share (note 10) | <u>(0.01)</u> | <u>(0.09)</u> | <u>(0.09)</u> | <u>(0.10)</u> |

See accompanying notes to the unaudited condensed interim financial statements.

The Second Cup Ltd.

Condensed Interim Statements of Changes in Shareholders' Equity
(Unaudited, expressed in thousands of Canadian dollars)

| | Share Capital | Contributed Surplus | Deficit | Total |
|---|--------------------------|--------------------------------|--------------------|------------------|
| Balance - December 27, 2014 | \$ 8,652 | \$ 61,649 | \$ (45,308) | \$ 24,992 |
| Net loss for the period | - | - | (1,247) | (1,247) |
| Stock option plan expense | - | 61 | - | 61 |
| Balance – September 26, 2015 | <u>\$ 8,652</u> | <u>\$ 61,710</u> | <u>\$ (46,556)</u> | <u>\$ 23,806</u> |
| | | | | |
| Balance - December 26, 2015 | \$ 8,652 | \$ 61,736 | \$ (46,462) | \$ 23,927 |
| Net loss for the period | - | - | (1,122) | (1,122) |
| Stock option plan expense | - | 49 | - | 49 |
| Balance – September 24, 2016 | <u>\$ 8,652</u> | <u>\$ 61,785</u> | <u>\$ (47,584)</u> | <u>\$ 22,854</u> |

See accompanying notes to the unaudited condensed interim financial statements.

The Second Cup Ltd.

Condensed Interim Statements of Cash Flows

(Unaudited, expressed in thousands of Canadian dollars)

| | 13 weeks ended | | 39 weeks ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| CASH PROVIDED BY (USED IN) | | | | |
| Operating activities | | | | |
| Net loss for the period | \$ (75) | \$ (1,099) | \$ (1,122) | \$ (1,247) |
| Items not involving cash | | | | |
| Depreciation of property and equipment | 287 | 267 | 894 | 807 |
| Amortization of intangible assets | 101 | 119 | 306 | 270 |
| Share-based compensation expense | 17 | 24 | 49 | 61 |
| Deferred income taxes | (12) | (348) | (323) | (443) |
| Loss (gain) on disposal of capital related items | 151 | 45 | 309 | (43) |
| Change in fair value of interest rate swap | (18) | (6) | (59) | 32 |
| Changes in non-cash working capital & other | (183) | 927 | (828) | 610 |
| | <u>268</u> | <u>(71)</u> | <u>(774)</u> | <u>47</u> |
| Cash provided by (used in) operating activities | | | | |
| Investing activities | | | | |
| Proceeds from disposal of capital related items | 31 | 77 | 113 | 305 |
| Cash payments for capital expenditures | (88) | (331) | (292) | (964) |
| Cash payments for intangible assets | (62) | (167) | (276) | (581) |
| Proceeds from repayment of leases receivable | 20 | 42 | 67 | 72 |
| Proceeds from repayment of notes receivable | 15 | 8 | 42 | 15 |
| | <u>(84)</u> | <u>(371)</u> | <u>(346)</u> | <u>(1,153)</u> |
| Cash used in investing activities | | | | |
| Cash used in financing activities | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| | | | | |
| Increase (decrease) in cash and cash equivalents during the period | 184 | (442) | (1,120) | (1,106) |
| Cash and cash equivalents - Beginning of period | <u>1,776</u> | <u>10,254</u> | <u>3,080</u> | <u>10,918</u> |
| Cash and cash equivalents - End of period | <u>\$ 1,960</u> | <u>\$ 9,812</u> | <u>\$ 1,960</u> | <u>\$ 9,812</u> |

See accompanying notes to the unaudited condensed interim financial statements. Supplemental cash flow information is provided in note 11.

The Second Cup Ltd.

Notes to the Condensed Interim Financial Statements

September 24, 2016 and September 26, 2015

(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

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1. Liquidity

The Company's credit facility of \$5,996,000 matures on January 1, 2017 and as a result has been classified as a current liability. Based on expected cash flows from operations, the Company will not generate sufficient funds from operations to repay the debt on January 1, 2017 and will need to generate funds from other sources as well as continue to comply with required bank covenants for the existing debt on a quarterly basis.

In recognition of these circumstances, the Company is actively pursuing alternative forms of financing to repay this debt including negotiating with its current lender, obtaining financing with other lenders, financing from significant shareholders or a private placement with certain shareholders by year end. Management plans to secure the necessary financing to replace the maturing debt through a combination of the above initiatives, nevertheless, there is no assurance that these initiatives will be successful.

2. Organization and nature of business

The Second Cup Ltd. is a Canadian specialty coffee retailer with 298 cafés operating under the trade name, Second Cup™, in Canada, of which 26 are Company-operated and the balance are operated by franchisees.

Second Cup owns the trademarks, trade names, operating procedures and systems and other intellectual property used in connection with the operation of Second Cup cafés in Canada.

Second Cup was incorporated under the Business Corporations Act (Ontario) in 2011 and is domiciled in Canada. The address of its registered office is 6303 Airport Road, 2nd Floor, Mississauga, Ontario, L4V 1R8. The

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Company hereinafter refers to its head office activities as “Coffee Central”. The Company’s website is www.secondcup.com. The common shares of the Company are listed on the Toronto Stock Exchange under the symbol “SCU”.

3. Summary of significant accounting policies

a. Basis of preparation

These unaudited condensed interim financial statements for the 13 and 39 weeks ended September 24, 2016 and September 26, 2015 have been prepared in accordance with International Financial Reporting Standards (“IFRS”), as applicable to condensed interim financial reports including International Accounting Standard (IAS) 34, Interim Financial Reporting (“IAS 34”), and should be read in conjunction with the Company’s audited annual financial statements for the year ended December 26, 2015, which have been prepared in accordance with IFRS, as issued by the International Accounting Standards Board.

The accounting policies applied in these unaudited condensed interim financial statements are consistent with those of the previous financial year. The accounting policies are based on IFRS issued and outstanding as at October 27, 2016, the date the Board of Directors approved the unaudited condensed interim financial statements.

Second Cup’s fiscal year is such that each quarter will consist of 13 weeks and will end on the Saturday closest to the calendar quarter end. The fiscal year is made up of 52 or 53-week periods ending on the last Saturday of December. Fiscal 2016 is a 53-week period (2015 – 52-week period).

b. Segmented information and reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the Chief Executive Officer. The Company substantially operates and is managed as one reportable segment. Operating revenues are comprised of royalties, the sale of goods from Company-operated cafés, the sale of goods through retail and other ancillary channels, and other service fees.

4. Changes in accounting policies

The accounting policies adopted in the preparation of these unaudited condensed interim consolidated financial statements are consistent with those followed in the preparation of the Company’s audited financial statements for the year ended December 26, 2015. There were no significant accounting policies adopted during the third quarter of 2016.

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Notes to the Condensed Interim Financial Statements

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(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

5. Provisions

Provisions for café leases are estimates for costs to be incurred by the Company as a result of closure of cafés and franchisee failure to make payment of occupancy costs.

An expense of \$430 (September 26, 2015 – expense of \$844) was recognized in the 39 weeks ended September 24, 2016 and was reflected in the franchise operating costs and expenses line on the unaudited condensed interim statements of loss and comprehensive loss.

6. Term debt

| | September 24, 2016 | December 26, 2015 |
|-------------------------------|--------------------|-------------------|
| Face value of borrowings | \$ 6,000 | \$ 6,000 |
| Unamortized transaction costs | <u>(4)</u> | <u>(23)</u> |
| | <u>\$ 5,996</u> | <u>\$ 5,977</u> |

Further to the Company's liquidity discussed in note 1, the credit facility is comprised of a \$6,000 (December 26, 2015 - \$6,000) non-revolving term loan. The loan is collateralized by substantially all the assets of the Company and matures on January 1, 2017.

The Company amended its term loan in 2015, which included repaying \$5,000, eliminating the credit facility of \$2,000, extending the maturity to 2017 and revising certain financial covenants. Pursuant to the terms of the Company's amended term loan, the Company is subject to certain financial and other customary covenants. The Company is required to maintain certain covenants which are based on a trailing four-quarter basis and are defined in the agreements as follows:

- a minimum EBITDA amount for each of the four quarters; and
- a fixed charge coverage ratio

The facility matures on January 1, 2017 and bears interest at the bankers' acceptance ("BA") rate plus a margin range of 2.25% to 3.25% based on the Company's leverage ratio. As at September 24, 2016, the applicable margin pertaining to the aforementioned range is 3.25% (December 26, 2015 - 3.25%).

The Company has an interest rate swap agreement with a notional value of \$6,000 that expires on September 30, 2016. The swap fixes the interest rate on the Company's non-revolving term credit facility at 2.07% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.32%.

As at September 24, 2016, there was an interest rate swap liability of \$18 recorded in other current liabilities in the Statements of Financial Position (December 26, 2015 - \$77).

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Notes to the Condensed Interim Financial Statements

September 24, 2016 and September 26, 2015

(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

7. Revenue

| | 13 weeks ended | | 39 weeks ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Franchise Revenue | | | | |
| Royalties | \$ 2,428 | \$ 2,464 | \$ 7,446 | \$ 7,671 |
| Services and other | 1,599 | 1,103 | 3,952 | 3,458 |
| | <u>4,027</u> | <u>3,567</u> | <u>11,398</u> | <u>11,129</u> |
| Company-owned cafés and product sales | <u>3,629</u> | <u>5,703</u> | <u>11,453</u> | <u>16,576</u> |
| | <u>\$ 7,656</u> | <u>\$ 9,270</u> | <u>\$ 22,851</u> | <u>\$ 27,705</u> |

Royalties

Royalty revenue from franchised cafés is based on agreed percentage royalty rates of the franchise location sales. Revenue is recognized on an accrual basis in accordance with the substance of the relevant agreement, provided that it is probable that the economic benefits will flow to the Company and the amount of revenue can be measured reliably.

Services and other

Services and other consist of initial franchise fees, renewal fees, transfer fees earned on the sale of cafés from one franchisee to another, construction administration fees, purchasing coordination fees, and other ancillary fees (such as IT support and training fees).

Company-owned cafés and product sales

Company owned cafés and product sales revenue includes the sale of goods from Company-owned cafés, as well as products sold in grocery stores through wholesale distribution channels and third party licensing agreements.

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Notes to the Condensed Interim Financial Statements

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(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

8. Operating costs and expenses

| | 13 weeks ended | | 39 weeks ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Company-owned cafés and cost of product sales | | | | |
| Cost of product sales | \$ 1,495 | \$ 2,297 | \$ 4,594 | \$ 6,401 |
| Labour and related expenses | 1,147 | 1,895 | 3,796 | 5,540 |
| Occupancy and other | 1,215 | 1,649 | 3,882 | 4,746 |
| Depreciation of property and equipment | 95 | 94 | 306 | 301 |
| Loss (gain) on disposal of assets | 151 | 45 | 309 | (43) |
| | <u>4,103</u> | <u>5,980</u> | <u>12,887</u> | <u>16,945</u> |
| Franchise | | | | |
| Labour and related expenses | 1,037 | 1,115 | 3,279 | 3,049 |
| Travel and franchisee meetings | 103 | 114 | 550 | 738 |
| Business development initiatives | - | 71 | - | 613 |
| Professional fees and other | 748 | 1,804 | 2,268 | 2,609 |
| | <u>1,888</u> | <u>3,104</u> | <u>6,097</u> | <u>7,009</u> |
| General and administrative | | | | |
| Labour and related expenses | 502 | 431 | 1,504 | 1,995 |
| Professional fees and other | 791 | 664 | 2,438 | 1,897 |
| Occupancy | 110 | 109 | 334 | 330 |
| Depreciation and amortization | 287 | 292 | 877 | 777 |
| | <u>1,690</u> | <u>1,496</u> | <u>5,153</u> | <u>4,999</u> |
| | <u>\$ 7,681</u> | <u>\$ 10,580</u> | <u>\$ 24,137</u> | <u>\$ 28,953</u> |

The Second Cup Ltd.

Notes to the Condensed Interim Financial Statements

September 24, 2016 and September 26, 2015

(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

9. Interest and financing

| | 13 weeks ended | | 39 weeks ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Interest expense | \$ 64 | \$ 160 | \$ 164 | \$ 471 |
| Amortization of deferred financing costs | 6 | 5 | 19 | 17 |
| Interest income | (8) | (28) | (24) | (103) |
| | <u>\$ 62</u> | <u>\$ 137</u> | <u>\$ 159</u> | <u>\$ 385</u> |

10. Basic and diluted loss per share

Loss per share is based on the weighted average number of shares outstanding during the period. Basic and diluted loss per share is determined as follows:

| | 13 weeks ended | | 39 weeks ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Net loss | \$ (75) | \$ (1,099) | \$ (1,122) | \$ (1,247) |
| Weighted average number of shares issued and outstanding | <u>12,830,945</u> | <u>12,830,945</u> | <u>12,830,945</u> | <u>12,830,945</u> |
| Basic and diluted loss per share | <u>\$ (0.01)</u> | <u>\$ (0.09)</u> | <u>\$ (0.09)</u> | <u>\$ (0.10)</u> |

The Second Cup Ltd.

Notes to the Condensed Interim Financial Statements

September 24, 2016 and September 26, 2015

(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

11. Supplemental cash flow information

| | 13 weeks ended | | 39 weeks ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 24, 2016 | September 26, 2015 | September 24, 2016 | September 26, 2015 |
| Changes in non-cash working capital & other (inflow (outflow)): | | | | |
| Trade and other receivables | \$ 222 | \$ (379) | \$ 1,243 | \$ 1,383 |
| Notes and leases receivable | 3 | (33) | (19) | (32) |
| Inventories | (11) | (6) | (23) | (51) |
| Prepaid expenses and other assets | 90 | (141) | 204 | 41 |
| Accounts payable and accrued liabilities | 22 | 615 | (932) | (716) |
| Provisions | (8) | 962 | (608) | (77) |
| Other liabilities | (145) | (121) | (257) | (17) |
| Gift card liability | (92) | (113) | (723) | (820) |
| Deposits from franchisees & change in restricted cash | (340) | 94 | (371) | 243 |
| Income taxes | 76 | 49 | 658 | 656 |
| | <u>\$ (183)</u> | <u>\$ 927</u> | <u>\$ (828)</u> | <u>\$ 610</u> |

Cash payments for capital expenditures

| | | | | |
|------------------------------------|-----------------|-----------------|-----------------|-------------------|
| Purchase of property and equipment | \$ (88) | \$ (331) | \$ (292) | \$ (964) |
| Purchase of intangible assets | (62) | (167) | (276) | (581) |
| | <u>\$ (150)</u> | <u>\$ (498)</u> | <u>\$ (568)</u> | <u>\$ (1,545)</u> |

Supplementary information

| | | | | |
|---------------|-------|-------|--------|--------|
| Interest paid | \$ 72 | \$ 95 | \$ 186 | \$ 410 |
|---------------|-------|-------|--------|--------|

12. Restricted cash

The Company has established certain accounts that have been classified as restricted cash, which primarily represent a) deposits from franchisees for the cost of constructing a new café or the renovation of an existing café, and b) funds contributed and restricted for use in advertising and promotional programs where the Company is acting as an agent on behalf of the co-operative fund.

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Notes to the Condensed Interim Financial Statements

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(Unaudited, expressed in thousands of Canadian dollars, except per share amounts)

13. Contingencies, commitments and guarantees

The Company has lease commitments for Company-operated cafés and acts as the head tenant on most leases, which it in turn subleases to franchisees. To the extent the Company may be required to make rent payments due to headlease commitments, a provision has been recognized. The Company's lease commitments as at September 24, 2016 are as follows:

| | Headlease commitments | Sublease to franchisees | Net |
|--------------------|----------------------------------|------------------------------------|------------------|
| September 30, 2017 | \$ 18,467 | \$ 15,639 | \$ 2,828 |
| September 29, 2018 | 16,534 | 13,985 | 2,549 |
| September 28, 2019 | 14,686 | 12,128 | 2,558 |
| September 26, 2020 | 12,477 | 10,094 | 2,383 |
| September 25, 2021 | 10,082 | 8,000 | 2,082 |
| Thereafter | 27,748 | 22,056 | 5,692 |
| | <u>\$ 99,994</u> | <u>\$ 81,902</u> | <u>\$ 18,092</u> |

The Company believes it will have sufficient resources to meet the net commitment of \$18,092 over the term of the leases.

The Company is involved in litigation and other claims arising in the normal course of business. Judgment must be used to determine whether or not a claim has any merit, the amount of the claim and whether to record a provision, which is dependent on the potential success of the claim. It is believed that no significant losses or expenses will be incurred with such claims. However, there can be no assurance that unforeseen circumstances will not result in significant costs. The outcome of these actions is not determinable at this time, and adjustments, if any, will be recorded in the period of settlement.

Contracts are in place with third party companies to purchase the coffee that is sold in all cafés. In terms of these supply agreements, there is a guaranteed minimum volume of coffee purchases of \$713 USD (September 26, 2015 - \$2,990 USD) for the subsequent 12 months. The coffee purchase commitment is comprised of two components: unapplied futures commitment contracts and fixed price physical contracts.

Due to the Company acting as the primary coordinator of café construction costs on behalf of its franchisees and for Company-operated cafés, there is \$526 (September 26, 2015 - \$1,865) of contractual commitments pertaining to construction costs for new locations and renovations as at the end of the quarter. Construction costs financed for franchise projects are from deposits received from franchisees and for corporate projects from the Company's cash flows.

14. Related parties

Related parties are identified as key management, members of the Board of Directors and shareholders that effectively exercise significant influence over the Company. Such related parties include any entities acting with or on behalf of the aforementioned parties. There were no related party transactions in the reporting period.