

# **The Second Cup Ltd.**

## **Management's Discussion and Analysis**

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The following Management's Discussion and Analysis ("MD&A") has been prepared as of March 5, 2013 and is intended to assist in understanding the results of operations and financial condition of The Second Cup Ltd. ("Second Cup" or the "Company") for the 13 weeks (the "Quarter") and the year ended December 29, 2012, and should be read in conjunction with the audited financial statements of the Company and accompanying notes, which are available at [www.sedar.com](http://www.sedar.com). Past performance may not be indicative of future performance. All amounts are presented in thousands of Canadian dollars, unless otherwise indicated and have been prepared in accordance with International Financial Reporting Standards ("IFRS").

In this MD&A, the Company also reports certain non-IFRS measures such as system sales of cafés, same café sales growth, EBITDA and adjusted net income. System sales of cafés and same café sales are discussed below under "System Sales". EBITDA represents earnings before interest, taxes, depreciation, amortization and impairment charges. As there is no generally accepted method of calculating EBITDA, the measure as calculated by the Company might not be comparable to similarly titled measures reported by other issuers. EBITDA is presented as management believes it is a useful indicator of the Company's ability to meet debt service and capital expenditure requirements and because management interprets trends in EBITDA as an indicator of relative operating performance. EBITDA should not be considered by an investor as an alternative to net income or cash flows as determined in accordance with IFRS.

As previously discussed, the Company (formerly Second Cup Income Fund) (the "Fund") converted from an income trust structure to a public corporation ("Conversion") on January 1, 2011. The Fund was not subject to income taxes to the extent that its taxable income was distributed to unitholders. On the IFRS transition date of January 1, 2010 an increase in the deferred tax liability was recorded by the Fund reflecting the highest marginal tax rate. After Conversion, the lower corporate tax rate resulted in a reduction in the deferred tax liability in 2011. The Company performed an impairment test on its franchise business cash generating unit (discussed below under "Operating Expenses") and recorded an impairment charge of \$15,294 related to goodwill and trademarks for 2012. Management has separated the 2011 deferred income tax recovery due to Conversion and the 2012 impairment of goodwill and trademarks resulting in the non-IFRS measures of adjusted net income and adjusted basic and diluted earnings per share.

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### **OVERVIEW AND BUSINESS OF SECOND CUP**

Second Cup is Canada's largest specialty coffee café franchisor and retailer (as measured by the number of cafés) with 360 cafés operating under the trade name Second Cup™ in Canada, of which ten are Company-operated and the balance are operated by franchise partners who are selected and trained to retail Second Cup's product offering.

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 only in Canada, excluding the Territory of Nunavut.

Second Cup is incorporated and domiciled in Canada. The address of its registered office is 6303 Airport Road, 2<sup>nd</sup> Floor, Mississauga, Ontario L4V 1R8. The Company's website is [www.secondcup.com](http://www.secondcup.com).

Second Cup's fiscal year follows the method implemented by many retail entities, 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.

The common shares of the Company are listed on the Toronto Stock Exchange under the symbol "SCU."

As at March 5, 2013, the Company's issued share capital consisted of 9,903,045 common shares, unchanged from year end.

Additional information relating to the Company, including the Company's Annual Information Form, is on SEDAR at [www.sedar.com](http://www.sedar.com).

### **BASIS OF PRESENTATION**

The financial statements of Second Cup have been prepared in accordance with IFRS and International Financial Reporting Interpretation Committee ("IFRIC") interpretations.

The preparation of financial statements in accordance with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note 4 of the financial statements.

The accounting policies applied in the financial statements are based on IFRS effective for the fiscal year ended December 29, 2012, as issued and outstanding as of February 28, 2013, the date the Board of Directors approved the financial statements.

The company's business is classified as one operating segment that is reported in a manner consistent with the internal reporting provided to the chief operating decision maker. The Company is structured as a franchisor with all of its operating revenues derived in Canada. Operating revenues comprise the sale of goods from Company-operated cafés and the sale of goods through ancillary channels, royalties and other service fees. Management is organized based on the Company's operations as a whole rather than the specific revenue streams.

As a franchisor, Second Cup opens, acquires, closes and refranchises individual café locations in the normal course of business.

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### FINANCIAL HIGHLIGHTS

The following table sets out selected IFRS financial information and other data of the Company and should be read in conjunction with the audited financial statements of the Company.

(in thousands of Canadian dollars, except number of cafés and per share amounts)	13 weeks ended December 29, 2012	13 weeks ended December 31, 2011	52 weeks ended December 29, 2012	52 weeks ended December 31, 2011
System sales of cafés <sup>1</sup>	\$53,515	\$54,404	\$194,387	\$193,660
Number of cafés – end of period	360	359	360	359
Same café sales growth <sup>1</sup>	(4.2%)	1.2%	(1.9%)	(0.1%)
Total revenue	\$7,785	\$7,363	\$26,346	\$25,001
Gross profit	\$6,638	\$6,603	\$22,823	\$22,778
Operating expenses	4,332	3,393	15,779	13,176
Impairment of goodwill and trademarks	15,294	-	15,294	-
Operating (loss) income	(\$12,988)	\$3,210	(\$8,250)	\$9,602
Amortization of property and equipment and intangible assets	324	287	1,167	832
Loss on disposal of property and equipment	42	20	70	36
Impairment of property and equipment	355	130	362	130
Impairment of goodwill and trademarks	15,294	-	15,294	-
Income before interest, tax, depreciation, amortization and impairment (“EBITDA”) <sup>1</sup>	\$3,027	\$3,647	\$8,643	\$10,600
(Loss) income before income taxes	(\$13,116)	\$3,116	(\$8,753)	\$8,887
Current income tax (charge)	(596)	(894)	(1,644)	(1,527)
Deferred income tax recovery (charge) excluding Conversion	1,688	(106)	993	(1,002)
Deferred income tax recovery due to Conversion <sup>2</sup>	-	236	-	6,943
Net (loss) income for the period	(\$12,024)	\$2,352	(\$9,404)	\$13,301
Deferred income tax recovery due to Conversion <sup>2</sup>	-	(236)	-	(6,943)
Impairment of goodwill and trademarks	15,294	-	15,294	-
Tax effect	(1,703)	-	(1,703)	-
Adjusted net income <sup>1</sup>	\$1,567	\$2,116	\$4,187	\$6,358
Basic and diluted (loss) earnings per share as reported	(\$1.21)	\$0.23	(\$0.95)	\$1.34
Adjusted basic and diluted earnings per share <sup>1</sup>	\$0.16	\$0.21	\$0.42	\$0.64
Total assets	\$88,680	\$105,554	\$88,680	\$105,554

<sup>1</sup> “System sales of cafés”, “Same café sales growth”, “EBITDA”, “Adjusted net income” and “Adjusted basic and diluted earnings per share” are not recognized performance measures under IFRS and, accordingly, may not be comparable to similar computations as reported by other issuers.

<sup>2</sup> At the annual and special meeting of unitholders held on June 10, 2010, the unitholders approved the proposed conversion from an income trust structure to a public corporation (“Conversion”). The Conversion was completed on January 1, 2011.

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### **SYSTEM SALES**

#### *Overview of System Sales*

System sales comprise the gross revenue reported to Second Cup by franchisees of Second Cup cafés and by cafés owned by Second Cup. Sales are reported by franchisees to Second Cup on a weekly basis without audit or other form of independent assurance. Second Cup's substantiation of sales reported by its franchisees is through analytical and financial reviews performed by management, comparison to sales data on the Point of Sales System ("POS"), on-site visits and analyses of raw materials purchased by the cafés as reported by authorized vendors.

Increases in system sales result from the addition of new cafés and same café sales growth. System sales from existing cafés are primarily dependent on pricing, product and marketing initiatives undertaken by Second Cup, maintaining operational excellence within the café network and general market conditions, including weather, disposable consumer income, consumer confidence, recessionary and inflationary trends, job security and unemployment, equity market levels, consumer credit availability and competitive activities. The primary factors influencing the number of cafés added to the Second Cup café network include the availability and cost of high quality locations, competition from other specialty coffee retailers and other businesses for prime locations, and the availability of qualified franchisees.

System sales are also affected by the permanent closure of Second Cup cafés. Cafés are closed when they cease to be viable or, occasionally, when a renewal of a lease for a particular location is not available or when an alternative, more preferable location is available.

#### *Analysis of System Sales and Same Café Sales Growth*

System sales for the 13 weeks ended December 29, 2012 were \$53,515 compared to \$54,404 for the 13 weeks ended December 31, 2011, representing a decrease of \$889 or 1.6%. The total number of cafés at the end of the Quarter was 360 compared to 359 cafés at the end of the fourth quarter of 2011.

System sales for the 52 weeks ended December 29, 2012 were \$194,387, compared to \$193,660 for the 52 weeks ended December 31, 2011, representing an increase of \$727 or 0.4%.

Same café sales represents percentage change, on average, in retail sales at cafés (franchised and Company-operated) operating system wide that have been open for 15 or more months. It is one of the key metrics the Company uses to assess its performance and provides a useful comparison between quarters. The two principal factors that affect same café sales growth are changes in customer traffic and changes in average check. These factors are dependent upon existing cafés maintaining operational excellence within each Second Cup café, general market conditions, pricing and marketing programs undertaken by Second Cup.

During the Quarter Second Cup continued to be impacted by increased competitive activity resulting in a same café sales decline of 4.2%, compared to an increase of 1.2% in the comparable quarter of 2011. For 2012, same café sales decline was 1.9% (2011 – 0.1% decline).

Management is not aware of any reliable third party comparable data on the trends affecting the Canadian specialty coffee market or the performance of Second Cup's competitors in the Canadian specialty coffee market during the year.

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### *Seasonality of System Sales*

The following table shows the percentage of annual system sales achieved, on average, in each fiscal reporting quarter over the last three fiscal years:

% of Annual System Sales	2010	2011	2012	Average
First quarter	23.8	23.5	24.2	23.9
Second quarter	24.4	24.4	24.4	24.4
Third quarter	24.0	24.0	23.9	23.9
Fourth quarter	27.8	28.1	27.5	27.8
	100.0	100.0	100.0	100.0

Historically, revenue has been higher in the fourth quarter, which includes the holiday sales periods of November and December. Because of this seasonality, the results for any quarter are not necessarily indicative of what may be achieved for any other quarter or for the full fiscal year.

### **CAFÉ NETWORK**

	13 weeks ended		52 weeks ended	
	Dec. 29, 2012	Dec. 31, 2011	Dec. 29, 2012	Dec. 31, 2011
Number of cafés - beginning of period	358	359	359	349
Cafés opened	4	7	18	22
Cafés closed	(2)	(7)	(17)	(12)
Number of cafés - end of period	360	359	360	359
Number of cafés renovated	4	6	19	25

During the Quarter, four cafés were renovated (2011 - six), there were four café openings (2011 - seven) and two café closures (2011 - seven) with 360 cafés open at December 29, 2012. For the year, 19 cafés (2011 - 25) were renovated; there were 18 café openings (2011 - 22) and 17 café closures (2011 - 12).

### **INCOME, OPERATING EXPENSES AND NET INCOME**

#### **Fourth Quarter**

##### *Analysis of Revenues*

Total revenues for the Quarter were \$7,785 (2011 - \$7,363) and consisted of royalty revenue, revenue from sale of goods and services revenue.

Royalty revenue for the Quarter was \$4,017 (2011 - \$4,346). The reduction in royalty revenue of \$329 was mainly due to a decrease in system sales and a reduction in the effective royalty rate (excluding sales from Company-operated cafés) from 8.1% in 2011 to 7.7% in the Quarter as a result of the revised royalty structure for new cafés. New cafés that opened in 2011 and 2012 pay a royalty rate of 3% in the first year, a rate of 6% in the second year and, thereafter, a rate of 9%. In addition the effective royalty rate was impacted by café specific arrangements in place during the period.

Revenue from the sale of goods, which includes revenue from Company-operated cafés and the sale of coffee through wholesale and retail channels, was \$1,597, compared to \$1,042 for the 13 weeks ended December 31,

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2011. The increase in revenue from the sale of goods was mainly due to operating twelve Company-operated cafés for most of the fourth quarter in 2012 compared to nine for most of the fourth quarter in 2011. The Company franchised two cafés late in the Quarter, ending the Quarter with ten Company-operated cafés.

Services revenue for the Quarter was \$2,171 (2011 - \$1,975). Services revenue includes initial franchise fees, renewal fees, transfer fees earned on the sale of cafés from one franchise partner to another, construction administration fees, product licencing revenue, purchasing coordination fees and other ancillary fees (IT support, tuition and construction black line drawings). The \$196 increase in services revenue is mainly due to an increase in product licencing revenue, transfer fees and other ancillary fees offset by decreases in initial franchise fees and purchasing coordination fees. The increase in product licence revenue was as a result of the new partnership with Kraft Canada Inc. to produce, market and sell Second Cup signature blend coffees and lattes across Canada using the TASSIMO T-Disc on-demand beverage system.

#### ***Cost of Goods Sold***

Cost of goods sold represents the product cost of goods sold in corporate cafés and through retail and wholesale channels plus the cost of direct labour to prepare and deliver the goods to the customers in the cafés. Cost of goods sold as a percentage of revenue from the sale of goods was 72% in the Quarter (2011 - 73%).

#### ***Operating Expenses***

Operating expenses include the head office expenses of Second Cup and the overhead expenses of Company-operated cafés. Total operating expenses were \$4,332 (2011 - \$3,393), an increase of \$939.

#### ***Head Office Operating Expenses***

Head office expenses of Second Cup increased by \$567 (19.8%) from \$2,857 in 2011 to \$3,424. Comparatively, the major expenses for the Quarter were salaries, wages and benefits \$1,484 (2011 - \$1,611), occupancy and lease costs \$589 (2011 - \$329), head office overheads \$282 (2011 - \$215), travel and franchise partner meetings \$202 (2011 - \$193), professional fees \$164 (2011 - \$84), legal costs \$160 (2011 - \$120), amortization of property and equipment \$137 (2011 - \$110), amortization of intangible assets \$116 (2011 - \$105), research and innovation \$115 (2011 - \$nil), advertising and franchise development \$93 (2011 - \$76), inventory markdowns \$46 (2011 - \$7), and bad debt expense \$36 (2011 - \$7). All material changes in operating expenses are explained in the table below.

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<i>Expenses</i>	<i>Increase / Decrease in Expenses</i>	<i>Explanation for Change</i>
Salaries, wages and benefits	Decrease of \$127	Reduction in incentives, severance costs, Directors' deferred share unit plan ("DSUP") and long-term incentive plan ("LTIP") offset by increases in Directors' fees and inflationary increases in salaries, wages and benefits. Directors' fees increased as a result of an additional Director in 2012.
Occupancy and lease costs	Increase of \$260	Increase in provision for vacant properties which had not been sublet offset by recoveries for rent arrears from franchise partners.
Research and innovation	Increase of \$115	New expenditure on test concepts and initiatives to build the brand and drive growth.
Professional fees	Increase of \$80	Primarily due to the partial outsourcing of the cafés IT network support and upgrading head office accounting software and help desk software.
Head office overheads	Increase of \$67	Increase in POS support costs as a result of an increase in the install base.
Legal costs	Increase of \$40	Increased litigation costs in preparation for a trial from an outstanding 2009 landlord claim and due to increased leasing activity.

***Impairment of Goodwill and Trademarks***

The Company considers the franchise business as a separate cash generating unit ("CGU"). The Company performed its annual impairment test on the franchise business CGU and the valuation based on the forecasted cash flows and using an 11.5% discount rate indicated impairment. As a result, the Company recognized a total impairment charge of \$15,294 which consisted of \$2,444 to goodwill and \$12,850 to trademarks in the Quarter. The after tax impact of these impairment charges were \$13,591 and reduced earnings per share by \$1.37. The impairment charges have no impact on the Company's liquidity, cash flow, borrowing capability or operations.



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#### *Corporate Café Operating Expenses*

The overhead expenses in Company-operated cafés increased by \$372 from \$536 in 2011 to \$908. Comparatively, the expenses for the Quarter were impairment of property and equipment \$355 (2011 - \$130), lease costs \$282 (2011 - \$178), other operating expenses \$107 (2011 - \$102), amortization of property and equipment \$71 (2011 - \$72), advertising and local marketing \$51 (2011 - \$34) and a loss on disposal of property and equipment \$42 (2011 - \$20).

The valuation of corporate cafés CGU based on revenue growth and future cash flows indicated an impairment. As a result, the Company recorded a loss of \$355 (2011 - \$130) on the impairment of two (2011 – one) Company-operated cafés.

<i>Expenses</i>	<i>Increase / Decrease in Expenses</i>	<i>Explanation for Change</i>
Impairment of property and equipment	Increase of \$225	Leaseholds of two corporate cafés written off and property and equipment written down to their recoverable amount versus one corporate café (kiosk in mall) written down in 2011.
Lease costs	Increase of \$104	The Company had ten (2011 - seven) Company-operated cafés at the end of the Quarter. The reduction in the amortization of liabilities arising from the 2009 acquisition of the Company by the Fund was \$11.

#### *Other Income and Expenses*

The Company incurred interest expense of \$159 (2011 - \$177), and \$22 (2011 - \$18) in amortization of financing charges relating to the term loan. The Company also recorded a non-cash credit of \$47 (2011 - \$86) for the movement in the fair value of the derivative interest rate swap that fixes the interest rate on the Company's term loan. The Company earned other interest income of \$10 (2011 - \$20) primarily due to interest earned from short-term highly liquid bank investments with original maturities of three months or less and from notes receivable.

#### *Income Taxes*

Current income taxes of \$596 (2011 - \$894) were recorded in the Quarter. A deferred tax recovery of \$1,688 (2011 - recovery of \$130) was recorded in the Quarter. The deferred tax recovery was mainly due to the impairment charge of \$15,294 to goodwill and trademarks in the Quarter.

#### *EBITDA*

EBITDA for the Quarter was \$3,027 (2011 - \$3,647). The decrease in EBITDA was due to an increase in gross profit of \$35 offset by an increase in operating expenses of \$655 (excluding amortization, loss on disposal of property and equipment and impairment charges) as discussed above.

#### *Net Income*

The Company's net loss for the Quarter was \$12,024 or (\$1.21) per share, compared to net income of \$2,352 or \$0.23 per share in 2011. Excluding the after tax impact of the goodwill and trademark impairment charge of \$13,591 in 2012 and the Conversion deferred tax recovery of \$236 in 2011, adjusted net income for the Quarter was \$1,567 or \$0.16 per share, compared to \$2,116 or \$0.21 per share in 2011. The decline in adjusted net income of \$549 or \$0.05 was mainly due to the \$225 increase in impairment of property and equipment, the \$714 increase in operating expenses (excluding the \$225 impairment above), the \$34 increase in net interest expense, offset by a \$35 increase in gross profit and a \$389 decrease in income taxes (excluding the income tax impact of Conversion and goodwill and trademarks impairment).

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### *Reconciliation of Net (Loss) Income to EBITDA for the 13 Weeks Ended*

	Dec. 29, 2012	Dec. 31, 2011
Net (loss) income	(\$12,024)	\$2,352
Net interest expense	128	94
Income taxes (recovery)	(1,092)	764
Amortization of property and equipment	208	182
Amortization of intangible assets	116	105
Loss on disposal of property and equipment	42	20
Impairment of property and equipment	355	130
Impairment of goodwill and trademarks	15,294	-
	<hr/>	<hr/>
EBITDA	\$3,027	\$3,647

### **Full Year**

#### *Analysis of Revenues*

Revenues were \$26,346 compared to \$25,001 in 2011 and consisted of royalty revenue, revenue from the sale of goods and services revenue.

Royalty revenue was \$14,927 (2011 - \$15,631). The reduction in royalty revenue of \$704 was mainly due to a reduction in the effective royalty rate (excluding sales from Company-operated cafés) from 8.2% in 2011 to 7.9% as a result of the revised royalty structure for new cafés as well as café specific arrangements in place during the period.

Revenue from the sale of goods, which includes revenue from Company-operated cafés and the sale of coffee through wholesale and retail channels, was \$4,698 compared to \$3,006 for the 52 weeks ended December 31, 2011. The increase in revenue from the sale of goods was mainly due to an increase in the weighted average number of Company-operated cafés from six in 2011 to eight in 2012. The Company ended the year with ten (2011 - seven) Company-operated cafés.

Services revenue was \$6,721 (2011 - \$6,364). The \$357 increase in services revenue is mainly due to an increase in product licencing revenue, IT support fees, purchasing coordination fees and café resale fees offset by decreases in initial franchise fees, construction administration fees and renewal fees. Product licencing fees increased \$443 largely due to the new partnership agreement with Kraft Canada Inc. to produce, market and sell Second Cup signature blend coffees and lattes across Canada using the TASSIMO T-Disc on-demand beverage system. IT support fees increased \$172 and relate to POS implemented in the second half of 2011. Café resale fees increased \$37 and are recognized when title transfers on the sale of a café between franchise partners. There were 28 cafés sold (2011 - 33) during the year reflecting a higher average price per transaction. Excluding new corporate cafés, the Company opened 17 new franchised cafés compared to 21 in 2011 and as a result initial franchise fees decreased by \$178. Construction administration fees decreased by \$138 as a result of lower franchise renovation projects which decreased from 25 in 2011 to 17 in 2012. The decrease in renewal fees is due to timing as renewal fees are recognized at the commencement of a new franchise term.

#### *Cost of Goods Sold*

Cost of goods sold as a percentage of revenue from the sale of goods was 75% compared to 74% for the 52 weeks ended December 31, 2011.

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#### ***Operating Expenses***

Operating expenses include the head office expenses of Second Cup and the overhead expenses of Company-operated cafés. Operating expenses were \$15,779 (2011 - \$13,176), an increase of \$2,603.

#### ***Head Office Operating Expenses***

Head office expenses of Second Cup increased by \$1,744 from \$12,008 in 2011 to \$13,752 or 14.5%. Comparatively, the major expenses for the year ended December 29, 2012 were salaries, wages and benefits \$6,540 (2011 - \$7,311), occupancy and lease costs \$1,614 (2011 - \$882), travel and franchise partner meetings \$1,010 (2011 - \$888), head office overheads \$992 (2011 - \$833), professional fees \$632 (2011 - \$476), legal costs \$518 (2011 - \$394), amortization of property and equipment \$506 (2011 - \$289), research and innovation \$476 (2011 - \$nil), amortization of intangible assets \$451 (2011 - \$392), bad debt expense \$422 (2011 - \$257), advertising and franchise development \$304 (2011 - \$263) and inventory markdowns \$287 (2011 - \$23).

#### ***Impairment of Goodwill and Trademarks***

As discussed above, the Company recognized an impairment charge of \$2,444 to goodwill and \$12,850 to trademarks.

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<i>Expenses</i>	<i>Increase / Decrease in Expenses</i>	<i>Explanation for Change</i>
Salaries, wages and benefits	Decrease of \$771	Reduction in incentives, severance costs, and DSUP offset by increases in Directors' fees, LTIP and inflationary increases in salaries, wages and benefits. LTIP increased due to the number of shares granted in December 2011 offset by a decrease in the share price.
Occupancy and lease costs	Increase of \$732	The increase is mostly due to two vacant sites which have been vacant since 2009 and have not been successfully sublet.
Research and innovation	Increase of \$476	New expenditure on test concepts and initiatives to build the brand and drive growth.
Inventory markdowns	Increase of \$264	Inventory mark-downs increased as a result of 3 products which had sales below expectations.
Amortization of property and equipment	Increase of \$217	Increase due to an increase in amortization on POS hardware and head office leasehold amortization. The Second Cup head office was renovated in the fourth quarter of 2011.
Bad debt expense	Increase of \$165	Increase in the allowance for doubtful accounts and a discount factor for a promissory note.
Head office overheads	Increase of \$159	Increase in IT support costs related to a larger install base of new POS.
Professional fees	Increase of \$156	Primarily due to the partial outsourcing of the IT network support for cafés and upgrading head office accounting software and help desk software.
Legal costs	Increase of \$124	Increased use of external legal professionals as a result of staff vacancies in the legal department as well as increased real estate activity and litigation costs.
Travel and franchise partner meetings	Increase of \$122	Increase in the cost of the annual franchise partner convention and the induction program for new franchise partners.
Amortization of intangible assets	Increase of \$59	Increase due to a greater number of POS installed in cafés.
Advertising and franchise development	Increase of \$41	Increased new business development and advertising to attract new franchise partners.

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#### *Corporate Café Operating Expenses*

The overhead expenses in Company-operated cafés increased by \$859 to \$2,027 from \$1,168 in 2011. Comparatively, the major expenses for the 52 weeks ended December 29, 2012 were lease costs \$885 (2011 - \$504), impairment of property and equipment \$362 (2011 - \$130), other operating expenses \$350 (2011 - \$253), amortization of property and equipment \$210 (2011 - \$151), advertising and local marketing \$150 (2011 - \$94) and a loss on disposal of property and equipment \$70 (2011 - \$36).

As discussed above, the Company recorded a loss of \$362 (2011 - \$130) on the impairment of two Company-operated cafés.

<i>Expenses</i>	<i>Increase / Decrease in Expenses</i>	<i>Explanation for Change</i>
Lease costs	Increase of \$381	The Company had ten (2011 - seven) Company-operated cafés at the end of year. The reduction in the amortization of liabilities arising from the 2009 acquisition of the Company by the Fund was \$43.
Impairment of property and equipment	Increase of \$232	Leaseholds of two corporate cafés written off and property and equipment written down to their recoverable amount versus one corporate café (kiosk in a mall) written down in 2011.
Other operating expenses	Increase of \$97	Increased number of Company-operated cafés.
Advertising and local marketing	Increase of \$56	Increased number of Company-operated cafés resulted in increased revenue subject to a 3% Co-op Fund contribution.
Amortization of property and equipment	Increase of \$59	Increased number of Company-operated cafés.

#### *Other Income and Expenses*

The Company incurred interest expense of \$672 (2011 - \$717), and \$82 (2011 - \$72) in amortization of financing charges relating to the term loan. The reduction in interest expense is a result of renegotiating the term loan and operating credit facilities discussed below under "Term Loan, Operating Credit Facility and Interest Rate Swap". The Company also recorded a non-cash credit of \$206 (2011 - \$29) for the movement in the fair value of the derivative interest rate swap that fixes the interest rate on the Company's term loan. The Company earned other interest income of \$61 (2011 - \$67) primarily due to interest earned from short-term, highly liquid bank investments with original maturities of three months or less and from notes receivable.

#### *Income Taxes*

The income tax expense of \$651 (2011 - recovery of \$4,414) consists of:

- current income tax expense of \$1,644 (2011 - \$1,527);
- deferred income tax expense of \$480 (2011 - \$nil) due to the income tax rate change discussed below;
- deferred income tax recovery of \$nil (2011 - \$6,943), due to the Conversion; and
- deferred income tax (recovery) expense of (\$1,473) (2011 - expense of \$1,002), excluding the impact of the Conversion.

The increase in current income tax expense is a result of the Company reducing its 2011 current income taxes by utilizing tax losses carried forward from prior years. The Ontario 2012 budget was substantively enacted on June 20, 2012, freezing corporate tax cuts with the effect that the income tax rate would remain at 11.5% until the province can achieve a balanced budget. Previously, the corporate income tax rate was slated to

## The Second Cup Ltd.

### Management's Discussion and Analysis

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decrease to 10.0% by 2014. The impact of the income tax rate change is estimated to be a future income tax increase of \$480. The \$1,473 deferred tax recovery in 2012 was mainly due to the impairment charge of \$15,294 to goodwill and trademarks in the Quarter.

Prior to the Conversion in 2011, the Fund was an unincorporated open-ended trust and was not subject to income taxes to the extent that its taxable income was distributed to unitholders. As a result of new tax legislation substantively enacted on June 12, 2007, the Fund would have paid tax on distributions declared subsequent to January 1, 2011. As a result of this legislation, the Fund had provided for the future tax effect of existing temporary differences between the accounting and tax bases of assets and liabilities that were expected to reverse subsequent to January 1, 2011 at the specified investment flow through ("SIFT") entity tax rates under Canadian GAAP. Under IFRS, the taxation rate to apply to temporary differences of the Fund that were expected to reverse after 2010 was the highest marginal tax rate of 46.41% rather than the lower SIFT tax rate used previously of 28.25%. On the IFRS Transition Date, this IFRS adjustment resulted in an increase of \$7,495 to the deferred tax liability and a corresponding decrease to equity. As a corporation, the deferred tax liability is measured using the corporate tax rate of 28.16% and resulted in a reduction in the deferred tax liability of \$6,943 and a corresponding non-cash credit to income in the first quarter of 2011.

#### **EBITDA**

EBITDA was \$8,643 (2011 - \$10,600). The decline in EBITDA was due to an increase in gross profit of \$45 offset by an increase in operating expenses of \$2,002 (excluding amortization, loss on disposal of property and equipment and impairment charges) as discussed above.

#### **Net Income**

The Company's net loss was \$9,404 or \$0.95 per share, compared to net income of \$13,301 or \$1.34 per share in 2011. Excluding the 2011 deferred income tax recovery of \$6,943 due to Conversion and the 2012 after tax impairment of goodwill and trademarks of \$13,591, adjusted net income was \$4,187 (2011 - \$6,358). The reduction in adjusted net income of \$2,171 was mainly due to the non-cash \$232 increase in the impairment of property and equipment charge, the \$2,371 increase in operating expenses (excluding the \$232 impairment above) offset by the \$212 decrease in net interest expense (including a non-cash \$177 increase in the movement of the derivative interest rate swap), a \$45 increase in gross profit and a \$175 decrease in income taxes (excluding the recovery due to Conversion and the income tax impact of goodwill and trademarks impairment).

#### **Reconciliation of Net (Loss) Income to EBITDA for the 52 Weeks Ended**

	<b>Dec. 29, 2012</b>	<b>Dec. 31, 2011</b>
Net (loss) income	(\$9,404)	\$13,301
Net interest expense	503	715
Income taxes (recovery)	651	(4,414)
Amortization of property and equipment	716	440
Amortization of intangible assets	451	392
Loss on disposal of property and equipment	70	36
Impairment of property and equipment	362	130
Impairment of goodwill and trademarks	15,294	-
	<hr/>	<hr/>
EBITDA	\$8,643	\$10,600
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#### ***Dividend***

On February 28, 2013, the Board of Directors of Second Cup approved a dividend of \$0.085 per common share, payable on March 28, 2013 to shareholders of record at the close of business on March 15, 2013. The dividend will be considered an eligible dividend for income tax purposes.

The Company's dividend policy is to continue to pay a portion of earnings while retaining funds for organic growth initiatives. The determination to declare and make payable dividends from Second Cup is at the discretion of the Board of Directors of Second Cup and, until declared payable, Second Cup has no requirement to pay cash dividends to shareholders. Taking into account current economic conditions and their impact on the profitability of Second Cup, the Board of Directors will continually review the level of dividends paid by the Company and there can be no assurance that the amount of the dividend will remain at the current level.

#### ***Annual General Meeting of Shareholders***

The Board of Directors has set a record date of March 24, 2013 for the Annual General Meeting of shareholders. The Annual General Meeting will be held at 10:00 a.m. on Friday, May 3, 2013 at the offices of Stikeman Elliott LLP, 53rd Floor, 5300 Commerce Court West, 199 Bay Street, Toronto, Ontario.

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### SELECTED QUARTERLY INFORMATION

A discussion of the Company's previous interim results can be found in the Company's quarterly MD&A reports available at [www.sedar.com](http://www.sedar.com).

(in thousands of Canadian dollars, except number of cafés and per share amounts)	<i>Q4 2012<sup>1</sup></i>	<i>Q3 2012</i>	<i>Q2 2012</i>	<i>Q1 2012</i>
System sales of cafés <sup>2</sup>	\$53,515	\$46,389	\$47,382	\$47,101
Same café sales growth <sup>2</sup>	(4.2%)	(2.8%)	(1.5%)	0.4%
Number of cafés at end of period	360	358	356	355
Total revenue	\$7,785	\$6,378	\$6,175	\$6,008
Operating (loss) income for the period	(\$12,988)	\$1,133	\$2,063	\$1,542
Amortization of property and equipment and intangible assets	324	306	271	266
Loss (gain) on disposal of property and equipment	42	29	-	(1)
Impairment of property and equipment	355	-	-	7
Impairment of goodwill and trademarks	15,294	-	-	-
EBITDA <sup>2</sup>	\$3,027	\$1,468	\$2,334	\$1,814
Net (loss) income before income taxes	(\$13,116)	\$1,017	\$1,920	\$1,426
Current income tax charge	596	275	422	351
Deferred income tax (recovery) charge	(1,688)	(4)	656	43
Net (loss) income for the period	(\$12,024)	\$746	\$842	\$1,032
Basic/diluted (loss) earnings per share	(\$1.21)	\$0.08	\$0.09	\$0.10
Dividends declared per share	\$0.085	\$0.15	\$0.15	\$0.15
	<i>Q4 2011<sup>1,3</sup></i>	<i>Q3 2011<sup>3</sup></i>	<i>Q2 2011<sup>3</sup></i>	<i>Q1 2011<sup>3</sup></i>
System sales of cafés <sup>2</sup>	\$54,404	\$46,369	\$47,294	\$45,593
Same café sales growth <sup>2</sup>	1.2%	(0.1%)	0.3%	(2.3%)
Number of cafés at end of period	359	359	350	352
Total revenue	\$7,363	\$6,138	\$6,072	\$5,428
Operating income for the period	\$3,210	\$2,362	\$2,506	\$1,524
Amortization of property and equipment and intangible assets	287	219	185	141
Loss on disposal of property and equipment	20	9	-	7
Impairment of property and equipment	130	-	-	-
EBITDA <sup>2</sup>	\$3,647	\$2,590	\$2,691	\$1,672
Net income before income taxes	\$3,116	\$2,095	\$2,283	\$1,393
Current income tax charge	894	511	122	-
Deferred income tax (recovery) charge	(130)	(68)	616	(6,359)
Net income for the period	\$2,352	\$1,652	\$1,545	\$7,752
Basic/diluted earnings per share	\$0.23	\$0.17	\$0.16	\$0.78
Dividends declared per share	\$0.15	\$0.15	\$0.15	\$0.00

<sup>1</sup> The Company's fourth quarter system sales are higher than other quarters due to the seasonality of the business (see "Seasonality of System Sales" above).

<sup>2</sup> "System sales of cafés", "Same café sales growth" and "EBITDA" are not recognized performance measures under IFRS and, accordingly may not be comparable to similar computations as reported by other issuers.

<sup>3</sup> Results for 2011 include deferred income tax (recovery) charge of (\$6,756), \$85, (\$36) and (\$236) in the first, second, third and fourth quarters respectively, as a result of the Conversion to a public corporation from an income trust structure.



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## Management's Discussion and Analysis

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### LIQUIDITY AND CAPITAL RESOURCES

Second Cup collects royalties based on franchise partner system sales, franchise fees and other amounts from its franchise partners and also generates revenues from its Company-operated cafés. The performance of Second Cup franchise partners and Company-operated cafés could impact the ability of the Company to declare and pay dividends to its shareholders. For a more detailed discussion of the risks and uncertainties affecting the Company's liquidity, see "Risks and Uncertainties" below.

#### Fourth quarter

##### *Cash Flows for the 13 Weeks Ended*

	Dec. 29, 2012	Dec. 31, 2011
Cash flows from operating activities	\$1,765	\$3,574
Cash flows (used in) investing activities	(221)	(976)
Cash flows (used in) financing activities	(844)	(1,513)
	<hr/>	<hr/>
Increase (decrease) in cash during the period	\$700	\$1,085

Cash generated by operating activities was \$1,765 for the Quarter compared to \$3,574 for the same quarter last year. The decrease is the result of increases in non-cash working capital including income taxes and a decrease in net income.

During the Quarter, cash used in investing activities was \$221 (2011 - \$976). The Company purchased \$387 (2011 - \$966) of property and equipment and \$24 (2011 - \$63) of software primarily for POS. The Company received proceeds of \$159 (2011 - \$35) on the disposal of property and equipment. The Company received proceeds of \$31 (2011 - \$26) on the repayment of leases receivable and promissory notes.

Financing activities resulted in cash usage of \$844 (2011 - \$1,513). During the Quarter, Second Cup paid a dividend totalling \$842 (2011 - \$1,485). The Company also paid \$2 in financing charges related to the term loan. During 2011, the Company repaid \$25 on a note payable to a previous landlord and made payments of \$3.

#### Full Year

##### *Working Capital as at*

	Dec. 29, 2012	Dec. 31, 2011
Current assets	\$9,593	\$11,225
Current liabilities	10,649	12,025
	<hr/>	<hr/>
Working capital (deficiency)	(\$1,056)	(\$800)

The Company has a working capital deficiency of \$1,056 as of December 29, 2012. Second Cup has a gift card program that allows customers to prepay for future purchases by reloading a dollar value onto their gift cards. Current liabilities includes \$4,560 (2011 - \$4,353) gift card liability. The gift cards do not have an expiration date. The Company will honour all Second Cup gift cards presented for payment but may recognize breakage based on historical redemption patterns. Gift card holders are not entitled to any interest, dividends or returns on prepaid amounts and the Company does not charge a service fee. The gift card program continues to provide a source of working capital.

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#### *Cash Flows for the 52 Weeks Ended*

	Dec. 29, 2012	Dec. 31, 2011
Cash flows from operating activities	\$5,150	\$8,305
Cash flows (used in) investing activities	(1,367)	(2,925)
Cash flows (used in) financing activities	(5,368)	(5,328)
(Decrease) increase in cash during the year	(\$1,585)	\$52

Year to date, the Company generated cash from operations of \$5,150 compared to \$8,305 in 2011. The decrease is primarily the result of paying the 2011 income taxes of \$1,548 and the 2012 income tax installments of \$1,287.

Year to date, cash used by investing activities was \$1,367 (2011 - \$2,925). Second Cup purchased \$1,758 (2011 - \$2,731) of property and equipment primarily to renovate two corporate cafés, construct a new corporate café, purchase three cafés from franchise partners, POS and head office computer upgrades. In addition, \$180 (2011 - \$312) of software was purchased primarily for POS. Second Cup received proceeds of \$350 (2011 - \$49) on the disposal of property and equipment primarily from the sale of three cafés. The Company received proceeds of \$221 (2011 - \$97) on the repayment of leases receivable and promissory notes. During 2011, the Company agreed to finance certain franchisees \$50 to enable them to purchase certain equipment, furniture and fixtures, all of which are owned by the Company as the underlying security. During 2011, the Company invested \$291 in assets held for sale, which were sold for proceeds of \$313.

Financing activities resulted in cash usage of \$5,368 in 2012, compared to \$5,328 in 2011. Second Cup paid dividends totalling \$5,298 (2011 - \$4,456) and the December 2010 distribution to unitholders of \$759 in 2011. The Company repaid \$18 (2011 - \$101) on a note payable to a previous landlord and made payments of \$2 (2011 - \$12) on a long-term lease. Both the note payable and long-term lease have been fully repaid. The Company renegotiated its term loan and operating credit facilities and incurred \$50 in financing charges related to the extension of the term loan to May 31, 2015 (see "Term Loan, Operating Credit Facility and Interest Rate Swap" below).

The Company had cash and cash equivalents of \$3,880 at December 29, 2012 (December 31, 2011 - \$5,465). The Company continues to believe it has sufficient financial resources to pay future dividends and operating expenses when declared and due.

#### ***Term Loan, Operating Credit Facility and Interest Rate Swap***

On June 12, 2012, the Company renegotiated its term loan and operating credit facilities including an extension of the maturity of the credit facilities, to May 31, 2015 and a decrease in interest rates. The revised credit facilities comprise an \$11,000 non-revolving term credit facility, fully drawn, and an undrawn \$2,000 revolving credit facility. As a result of the refinancing, the Company capitalized loan extension fees of \$50. The term credit facilities are collateralized by substantially all the assets of the Company.

The \$11,000 non-revolving term credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, the full amount of the \$11,000 non-revolving term credit facility was drawn.

The \$2,000 operating credit facility bears interest at the bankers' acceptance rate plus 2.75% (December 31, 2011 - 3.50%). As at December 29, 2012, no advances had been drawn on this facility.

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The Company has an interest rate swap agreement with a notional value of \$11,000 maturing on April 1, 2013, which fixes the interest rate on the Company's non-revolving credit facility at 3.04% per annum plus the margin noted above, which results in a fixed effective interest rate of 5.79% (December 31, 2011 - 6.54%). As at December 29, 2012, the estimated fair value of this contract is a \$96 liability to the Company (December 31, 2011 - \$302) which is recorded as a liability on the Company's Statements of Financial Position, and the fair value movement of the interest rate swap has been recorded as a non-cash credit to income on the Company's Statements of Operations and Comprehensive Income (Loss).

Pursuant to the terms of the Company's operating loan and term loan, the Company is subject to certain financial and other customary covenants, including requirements to maintain a ratio of senior debt to EBITDA and to maintain a trailing four-quarter fixed charge coverage ratio. During the year ended December 29, 2012, the Company was in compliance with all financial and other covenants of the Company's operating loan and term loan.

In accordance with IFRS 7, Financial Instruments: Disclosures, the term loan is presented net of transaction costs. Transaction costs are amortized to the Statements of Operations and Comprehensive Income (Loss) using the effective interest method.

#### OFF-BALANCE SHEET ARRANGEMENTS

Second Cup has lease commitments for Company-operated cafés and also acts as the head tenant on leases, which it, in turn, subleases to franchise partners. The Company's lease commitments at December 29, 2012 are as follows:

	<b>Headlease commitments</b>	<b>Sublease to franchisees</b>	<b>Net</b>
December 31, 2013	\$ 19,246	\$ 17,867	\$ 1,379
December 31, 2014	18,346	17,121	1,225
December 31, 2015	16,710	15,474	1,236
December 31, 2016	14,676	13,430	1,246
December 31, 2017	12,667	11,501	1,166
Thereafter	<u>35,706</u>	<u>31,647</u>	<u>4,059</u>
	<u>\$ 117,351</u>	<u>\$ 107,040</u>	<u>\$ 10,311</u>

The Company believes it has sufficient resources to meet the net commitment of \$10,311.

Total occupancy and lease costs expensed in the year are as follows:

	<b>52 weeks ended December 29, 2012</b>	<b>52 weeks ended December 31, 2011</b>
Company head office and franchise café locations	\$ 1,614	\$ 882
Company-operated cafés	<u>885</u>	<u>504</u>
	<u>\$ 2,499</u>	<u>\$ 1,386</u>

Second Cup is involved in litigation and other claims arising in the normal course of business. Management must use its judgement 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. Second Cup believes

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that it will not incur any significant loss or expense 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.

The Coffee "C" contract is the world benchmark for Arabica coffee. The contract prices physical delivery of exchange grade green beans from one of 19 countries of origin in a licensed warehouse to one of several ports in the U.S. and Europe, with stated premiums / discounts for ports and growth. Second Cup sources high altitude Arabica coffee which tends to trade at a premium above the "C" coffee commodity price. Second Cup has a contract with a third party company to purchase and roast the coffee that is sold in all Second Cup cafés by franchise partners. In terms of this supply agreement, Second Cup has guaranteed a minimum volume of coffee purchases amounting to \$4,421 (2011 - \$9,462). The coffee purchase commitment represents purchase commitments made up to the end of December 2013. The coffee purchase commitment is comprised of three components: unapplied futures commitment contracts, fixed price physical contracts and flat price physical contracts. As at December 29, 2012 most of the unapplied futures commitments for 2013 had been contracted, however, only a portion of the physical contracts had been negotiated. As a result, the majority of the decrease in the total commitments was due to a planned delay in committing to certain fixed price physical contracts.

Second Cup has entered into a marketing agreement with a third party through 2014 and has committed to spend \$200 per year on advertising placed in various media offered by the third party over the term of the agreement.

#### **FUTURE ACCOUNTING STANDARDS**

##### ***Financial Instruments – Recognition and Measurement***

IFRS 9, Financial Instruments ("IFRS 9"), was issued in November 2009 and addresses classification and measurement of financial assets. It replaces the multiple category and measurement models in International Accounting Standard 39, Financial Instruments: Recognition and Measurement ("IAS 39") for debt instruments with a new mixed measurement model having only two categories: amortized cost and fair value through profit and loss. IFRS 9 also replaces the models for measuring equity instruments. Such instruments are either recognized at fair value through profit or loss or at fair value through other comprehensive income. Where equity instruments are measured at fair value through other comprehensive income, dividends are recognized in profit or loss to the extent that they do not clearly represent a return of investment; however, other gains and losses (including impairments) associated with such instruments remain in accumulated comprehensive income indefinitely.

Requirements for financial liabilities were added to IFRS 9 in October 2010 and they largely carried forward existing requirements in IAS 39, except that fair value changes due to credit risk for liabilities designated at fair value through profit and loss are generally recorded in other comprehensive income.

IFRS 13, Fair Value Measurement ("IFRS 13"), is a comprehensive standard for fair value measurement and disclosure for use across all IFRS. The new standard clarifies that fair value is the price that would be received to sell an asset, or paid to transfer a liability in an orderly transaction between market participants, at the measurement date. Under existing IFRS, guidance on measuring and disclosing fair value is dispersed among the specific standards requiring fair value measurements and does not always reflect a clear measurement basis or consistent disclosures.

IFRS 9 and IFRS 13 are effective for annual periods beginning on or after January 1, 2015 and January 1, 2013, respectively, with earlier adoption permitted. The Company will adopt IFRS 13, effective January 1,

## The Second Cup Ltd.

### Management's Discussion and Analysis

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2013, but does not expect it to have a significant impact. The Company has not yet assessed the impact of IFRS 9 or determined whether it will early adopt the standard.

#### MANAGEMENT OF CAPITAL

The capital structure of the Company consists of \$10,941 (2011 - \$10,909) in long-term debt and \$56,700 (2011 - \$71,402) in shareholders' equity, which comprises issued shares and accumulated earnings, less accumulated cash distributions.

The Company's objectives relating to the management of its capital structure are to:

- a) safeguard its ability to continue as a going concern;
- b) maintain financial flexibility in order to preserve its ability to meet financial obligations;
- c) maintain a capital structure that provides financing options to the Company when the need arises to access capital;
- d) ensure it has sufficient cash and cash equivalents to pay declared dividends to its shareholders; and
- e) deploy capital to provide an adequate return to its shareholders.

The Company's primary uses of capital are to finance increases in non-cash working capital and capital expenditures.

The Company determines the appropriate level of long-term debt in the context of its cash flow and overall business risks. The Company has historically generated sufficient cash flows to pay quarterly dividends to its shareholders. In order to maintain or modify the capital structure, Second Cup may adjust the amount of dividends paid to its shareholders. The current level of capital is considered adequate in the context of current operations.

Under the term loan and operating facility, the Company is required to comply with a number of covenants and restrictions, including the requirements to meet certain financial ratios. These financial ratios include a senior leverage ratio and a fixed charge coverage ratio. To date, the Company has complied with these ratios.

There were no changes in the Company's approach to capital management during the Quarter.

#### OUTSTANDING SHARE AND UNIT DATA

	Income Fund Units		Share Capital	
	#	\$	#	\$
Balance December 31, 2010	9,903,045	89,972	-	-
Conversion January 1, 2011	(9,903,045)	(89,972)	9,903,045	89,972
Reduction in stated capital January 1, 2011	-	-	-	(88,972)
Balance December 31, 2011	-	-	9,903,045	1,000

At the annual and special meeting of unitholders held on June 2, 2010, the unitholders approved the Conversion to be undertaken on January 1, 2011. Included as part of the Conversion was a reduction in the stated capital from \$89,972 to \$1,000, resulting in a reduction of the deficit by \$27,575 and an increase in contributed surplus of \$61,397. The Conversion and the associated reduction in share capital were approved by court orders dated June 11, 2010 and December 17, 2010.

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### **EVALUATION OF DISCLOSURE CONTROLS AND PROCEDURES**

Multilateral Instrument 52-109 ("MI 52-109") requires the Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") to make certain certifications related to the information contained in the Company's annual filings. Specifically, the CEO and CFO must acknowledge that they are responsible for establishing and maintaining disclosure controls and procedures and internal control over financial reporting ("ICFR") for the Company. The control framework used by the CEO and CFO to design the Company's ICFR is Internal Control Over Financial Reporting – Guidance for Smaller Public Companies issued by COSO. In addition, in respect of:

#### **(a) Disclosure Controls and Procedures**

The CEO and CFO must certify that they have designed the disclosure controls and procedures, or caused them to be designed under their supervision, to provide reasonable assurance that material information relating to the Company is made known to them in a timely manner and that information required under securities legislation is recorded, processed, summarized and reported in a timely manner.

As at December 29, 2012, the Company's management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the disclosure controls and procedures. Based on this evaluation, the CEO and CFO have concluded that, as at December 29, 2012, the Company's disclosure controls and procedures were appropriately designed.

Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls and procedures should not exceed their expected benefits. As such, the Company's disclosure controls and procedures can only provide reasonable, and not absolute, assurance that the objectives of such controls and procedures are met.

#### **(b) Internal Controls Over Financial Reporting**

The CEO and CFO must certify that they have designed such internal controls over financial reporting, or caused them to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS.

As at December 29, 2012, the Company's management, under the supervision of, and with the participation of, the CEO and CFO, evaluated the design of the controls over financial reporting. No material weaknesses in the design of these controls over financial reporting were identified. Based on this evaluation, the CEO and CFO have concluded that, as at December 29, 2012, the Company's controls over financial reporting were appropriately designed and are operating effectively.

Consistent with the concept of reasonable assurance, the Company recognizes that the relative cost of maintaining these controls should not exceed their expected benefits. As such, the Company's internal controls over financial reporting can only provide reasonable, and not absolute, assurance that the objectives of such controls are met.

During the 52 weeks ended December 29, 2012, there has been no change in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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### CRITICAL ACCOUNTING ESTIMATES

The preparation of financial statements requires management to use judgement in applying its accounting policies and estimates and assumptions about the future. Estimates and other judgements are continuously evaluated and are based on management's experience and other factors, including expectations about future events that are believed to be reasonable under the circumstances. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognized in the period in which the estimates are revised and in any future periods affected.

The following discusses the most significant accounting judgements and estimates that the Company has made in the preparation of the financial statements:

#### *Impairment analysis*

Impairment analysis is an area involving management judgement requiring assessment as to whether the carrying value of assets is recoverable. Fair value less cost to sell is determined by estimating the net present value of future cash flows derived from such assets using cash flow projections, which have been discounted at an appropriate rate. In calculating the net present value of the future cash flows, certain assumptions are required to be made in respect of highly uncertain matters including:

- a) Growth in total revenue
- b) Growth in cash flows, calculated as adjusted operating profit before depreciation and amortization,
- c) Long term growth rates
- d) Selection of discount rates to reflect the risks involved.

Management has estimated cash flows based on market participant assumptions and expected future operations.

The discount rate is based upon a weighted average cost of capital derived from the benchmark analysis from similar retail or franchise businesses in Canada and the United States.

Changing the assumptions selected by management, in particular the discount rate and the growth rate assumptions used in the cash flow projections, could significantly affect the impairment evaluations and, hence, the results.

The Company's review includes the key assumptions related to sensitivity in the cash flow projections. Further details are provided in Note 13 to the financial statements.

#### *Recoverable amount and Cash Generating Units (CGUs)*

A CGU is defined as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Goodwill is not amortized but tested for impairment at least once a year or more frequently when there is an indication that it may be impaired.

An impairment test is performed at the level of each CGU within each operating segment. This allocation is reviewed if the Company changes the level at which it monitors goodwill or changes in operating segments.

An impairment charge is recognized when the carrying value of the assets and liabilities of the franchise business CGU is higher than its recoverable amount. The recoverable amount of the franchise business CGU was estimated based on fair value less costs to sell. Fair value less costs to sell is the best estimate of the amount obtainable from the sale of a CGU in an arm's length transaction between knowledgeable, willing

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parties, less costs to sell. This estimate is determined on December 29, 2012. The Company determined goodwill and trademarks were impaired and recognized an impairment charge of \$2,444 and \$12,850 respectively. The Company also determined the valuation of two corporate cafés indicated impairment and recognized an impairment charge of \$362 mainly related to leaseholds.

#### ***Deferred income taxes***

The timing of reversal of timing differences and the expected income allocation to various tax jurisdictions within Canada affect the effective income tax rate used to compute the deferred income tax asset. Management estimates the reversals and income allocation based on historical and budgeted operating results and income tax laws existing at the Statements of Financial Position date. In addition, management occasionally estimates the current or future deductibility of certain expenditures, affecting current or deferred income tax balances and expenses.

#### ***Fair value of derivative***

Second Cup's over-the-counter derivative consists of an interest rate swap used to economically hedge exposure to variable cash flows associated with interest payments on the Company's borrowings. Management estimates the fair value of this derivative as the present value of expected future cash flows to be received or paid, based on available market data, which includes market yields and counterparty credit spreads.

#### ***Estimated useful lives***

Management estimates the useful lives of property and equipment based on the period during which the assets are expected to be available-for-use. The amounts and timing of recorded expenses for amortization of property and equipment for any period are affected by these estimated useful lives. The estimates are reviewed at least annually and are updated if expectations change as a result of physical wear and tear, technical or commercial obsolescence and legal or other limits to use. It is possible that changes in these factors may cause significant changes in the estimated useful lives of the Company's property and equipment in the future.

#### ***Provisions***

Second Cup has lease commitments since it acts as the head tenant on café leases. In cases where the lease contract specifies a termination fee due to the landlord or a fee is negotiated with the landlord upon termination, the Company records the expense at the time written notice is given or agreed to by the landlord. When ceasing operations under operating leases where the landlord does not allow the Company to prematurely exit the lease, but allows for subleasing, the Company estimates the fair value of sublease income in calculating the provision to the end of the lease term.

### **RISKS AND UNCERTAINTIES**

The performance of Second Cup is primarily dependent on its ability to maintain and increase the sales of existing cafés, add new profitable cafés to the network and redevelop and modernize cafés as their leases come due. System sales of the Second Cup café network are affected by various external factors that can affect the specialty coffee industry as a whole. Potential risks include the following:

The specialty coffee industry is characterized by intense competition with respect to price, location, coffee and food quality and numerous factors affecting discretionary consumer spending. Competitors include national and regional chains, all restaurants and food service outlets that serve coffee and supermarkets that compete in the whole bean segment. If Second Cup cafés are unable to successfully compete in the Canadian specialty coffee industry, system sales may be adversely affected, which, in turn, may adversely affect the ability of Second Cup to pay dividends.



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Growth of the café network depends on Second Cup's ability to secure and build desirable locations and find high calibre qualified franchise partners to operate them. Adverse credit markets, such as those currently being experienced, may affect the ability of franchise partners to obtain new credit or refinance existing credit on economically reasonable terms.

Second Cup faces competition for café locations and franchise partners from its competitors and from franchisors and operators of other businesses. The success of Second Cup franchise partners is significantly influenced by the location of their cafés. There can be no assurance that current Second Cup café locations will continue to be attractive, or that additional café sites can be located and secured as demographic patterns change. Also, there is no guarantee that the property leases in respect of the Second Cup cafés will be renewed or suitable alternative locations will be obtained and, in such event, one or several cafés could be closed. It is possible that the current locations or economic conditions where Second Cup cafés are located could decline in the future, resulting in potentially reduced sales in those locations, which will have an adverse effect on System Sales. There is no assurance that future sites will produce the same results as past sites. There is also no assurance that a franchise partner will continue to pay its rental obligations in a timely manner, which could result in Second Cup being obligated to pay the rental obligations pursuant to its head lease commitment, which would adversely affect the profitability of Second Cup's business.

A shortage in supply or an increase in the price of premium quality coffee beans could adversely affect Second Cup. Second Cup has no material long-term contracts with coffee bean suppliers and relies on historical relationships to ensure availability. While there are a number of coffee bean suppliers, there can be no assurance that coffee bean suppliers that have relationships with Second Cup will continue to supply coffee beans at competitive prices.

The Canadian specialty coffee industry is also affected by changes in discretionary spending patterns, which are in turn dependent on consumer confidence, disposable consumer income and general economic conditions. Factors such as a change in general economic conditions, recessionary or inflationary trends, job security and unemployment, equity market levels, consumer credit availability and overall consumer confidence levels may affect their business. The specialty coffee industry is also affected by demographic trends and traffic and weather patterns as well as the type, number and location of competing cafés.

Second Cup relies heavily on information technology network infrastructure. The Company's ability to manage operations effectively and efficiently depends on the reliability and capacity of these technology systems, most of which are administered by third party suppliers. The Company relies on POS for system sales for both marketing trends and royalty calculations through the IT network infrastructure. Cafés rely on IT network infrastructure to order goods and process credit, debit and café card transactions. Head Office financial and administrative functions rely on IT infrastructure for accurate and reliable information. The failure of these systems to operate effectively, problems with upgrading or replacing systems could cause a material negative financial result. The Company is continually reviewing its systems and procedures to minimize risk.

Second Cup's business could be adversely affected by increased concerns about food safety in general or other unusual events.

As a Franchisor, Second Cup guarantees the lease of its franchise partners for most of its franchised cafés.

Changes in government regulations and other regulatory developments (such as smoking by-laws) could have an adverse impact on system sales and royalties.

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The loss of key personnel and/or a shortage of experienced management and hourly employees could have an adverse impact on Second Cup's operations and cafés.

A more detailed discussion of the risks and uncertainties affecting Second Cup is set out in the Second Cup's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

#### **OUTLOOK**

The information contained in this "Outlook" is forward-looking information. Please see "Forward-looking Information" below for a discussion of the risks and uncertainties in connection with forward-looking information.

The Second Cup business continues to operate in an increasingly competitive marketplace and a challenging consumer environment. For 2013, management will continue to re-invest in the business, specifically a loyalty and communications capability, a coffee revitalization plan, and a newly designed café. These initiatives will be in test in 2013 with expected roll-outs towards the end of the year. In addition, Second Cup will leverage new and growing commercial opportunities, including the expansion and support of the newly introduced Second Cup signature coffees and lattes using the TASSIMO T-Disc on demand beverage system and expects to increase its product licencing revenue as a result.

Second Cup will continue to improve the café network with the opening of cafés while closing below average performing cafés.

#### **FORWARD-LOOKING INFORMATION**

Certain statements in this MD&A may constitute forward-looking information within the meaning of applicable securities legislation. Forward-looking information can be identified by words such as "may", "will", "should", "expect", "anticipate", "believe", "plan", "intend" and other similar words. Forward-looking information reflects current expectations regarding future events and operating performance and speaks only as of the date of this MD&A. It should not be read as a guarantee of future performance or results and will not necessarily be an accurate indication of whether or not those results will be achieved. Forward-looking information is based on a number of assumptions and is subject to known and unknown risks, uncertainties and other factors, many of which are beyond Second Cup's control that may cause Second Cup's actual results, performance or achievements, or those of Second Cup cafés, or industry results to be materially different from any future results, performance or achievements expressed or implied by such forward-looking information. The following are some of the factors that could cause actual results to differ materially from those expressed in the underlying forward-looking information: competition; availability of premium quality coffee beans; the ability to attract qualified franchise partners; the location of Second Cup cafés; the closure of Second Cup cafés; loss of key personnel; compliance with government regulations; potential litigation; the ability to exploit and protect the Second Cup Marks; changing consumer preferences and discretionary spending patterns including, but not restricted to, the impact of weather and economic conditions on such patterns; reporting of system sales by franchise partners; and the results of operations and financial condition of Second Cup. The foregoing list of factors is not exhaustive, and investors should refer to the risks described under "Risks and Uncertainties" above and in Second Cup's Annual Information Form, which is available at [www.sedar.com](http://www.sedar.com).

Although the forward-looking information contained in this MD&A is based on what management believes are reasonable assumptions, there can be no assurance that actual results will be consistent with this forward-looking information and, as a result, the forward-looking information may prove to be incorrect.

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As these forward-looking statements are made as of the date of this MD&A, Second Cup does not undertake to update any such forward-looking information, whether as a result of new information, future events or otherwise. Additional information about these assumptions and risks and uncertainties is contained in the Company's filings with securities regulators. These filings are also available on the Company's website at [www.secondcup.com](http://www.secondcup.com).