

POTBELLY CORP
Form 10-Q
August 04, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the Quarterly Period Ended June 25, 2017

OR

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

For the Transition Period from _____ to _____

Commission File Number: 001-36104

Potbelly Corporation

(Exact name of registrant as specified in its charter)

Delaware 36-4466837
(State or Other Jurisdiction of (IRS Employer

Incorporation) Identification Number)
111 N. Canal Street, Suite 850

Chicago, Illinois 60606

(Address, including Zip Code, of Principal Executive Offices)

Registrant's telephone number, including area code: (312) 951-0600

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

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

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

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

Common stock, \$0.01 Par Value – 25,125,482 shares as of June 25, 2017

Potbelly Corporation and Subsidiaries

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Potbelly Corporation and Subsidiaries

Condensed Consolidated Balance Sheets

(amounts in thousands, except share and par value data, unaudited)

| | June 25, 2017 | December 25, 2016 |
|---------------------------------------------------------------------------------------------------------------------------------------|------------------|-------------------------|
| Assets | | |
| Current assets | | |
| Cash and cash equivalents | \$21,182 | \$23,379 |
| Accounts receivable, net of allowances of \$159 and \$78 as of June 25, 2017 and December 25, 2016, respectively | 5,576 | 3,787 |
| Inventories | 3,321 | 3,365 |
| Prepaid expenses and other current assets | 9,198 | 8,020 |
| Total current assets | 39,277 | 38,551 |
| Property and equipment, net | 105,270 | 107,074 |
| Indefinite-lived intangible assets | 3,404 | 3,404 |
| Goodwill | 2,222 | 2,222 |
| Deferred income taxes, non-current | 18,436 | 19,410 |
| Deferred expenses, net and other assets | 4,856 | 4,784 |
| Total assets | \$173,465 | \$175,445 |
| Liabilities and Equity | | |
| Current liabilities | | |
| Accounts payable | \$4,159 | \$3,111 |
| Accrued expenses | 19,721 | 23,082 |
| Accrued income taxes | 68 | 1,622 |
| Total current liabilities | 23,948 | 27,815 |
| Deferred rent and landlord allowances | 22,174 | 21,076 |
| Other long-term liabilities | 2,574 | 2,318 |
| Total liabilities | 48,696 | 51,209 |
| Stockholders' equity | | |
| Common stock, \$0.01 par value—authorized 200,000,000 shares; outstanding 25,125,482 and 25,139,127 shares as of June 25, 2017 and | 313 | 309 |

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| | | |
|--------------------------------------------------------------------|-----------|-----------|
| December 25, 2016, respectively | | |
| Warrants | — | 909 |
| Additional paid-in-capital | 413,539 | 407,622 |
| Treasury stock, held at cost, 6,166,996 and 5,753,412 shares as of | | |
| June 25, 2017, and December 25, 2016, respectively | (77,317) | (72,321) |
| Accumulated deficit | (212,489) | (213,034) |
| Total stockholders' equity | 124,046 | 123,485 |
| Non-controlling interest | 723 | 751 |
| Total stockholders' equity | 124,769 | 124,236 |
| Total liabilities and equity | \$173,465 | \$175,445 |

See accompanying notes to the unaudited condensed consolidated financial statements.

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Potbelly Corporation and Subsidiaries

Condensed Consolidated Statements of Operations

(amounts in thousands, except share and per share data, unaudited)

| | For the 13 Weeks Ended | | For the 26 Weeks Ended | |
|-----------------------------------------------------------|------------------------|------------------|------------------------|------------------|
| | June 25, 2017 | June 26, 2016 | June 25, 2017 | June 26, 2016 |
| Revenues | | | | |
| Sandwich shop sales, net | \$107,382 | \$104,466 | \$208,241 | \$199,892 |
| Franchise royalties and fees | 754 | 570 | 1,594 | 1,099 |
| Total revenues | 108,136 | 105,036 | 209,835 | 200,991 |
| Expenses | | | | |
| Sandwich shop operating expenses | | | | |
| Cost of goods sold, excluding depreciation | 28,635 | 28,500 | 55,298 | 54,746 |
| Labor and related expenses | 31,564 | 29,935 | 62,026 | 58,097 |
| Occupancy expenses | 14,269 | 13,174 | 28,438 | 25,931 |
| Other operating expenses | 12,252 | 10,687 | 23,885 | 21,232 |
| General and administrative expenses | 10,919 | 10,305 | 21,271 | 20,828 |
| Depreciation expense | 6,446 | 5,676 | 12,645 | 11,340 |
| Pre-opening costs | 546 | 239 | 619 | 391 |
| Impairment and loss on disposal of property and equipment | 3,341 | 1,008 | 4,226 | 1,025 |
| Total expenses | 107,972 | 99,524 | 208,408 | 193,590 |
| Income from operations | 164 | 5,512 | 1,427 | 7,401 |
| Interest expense | 41 | 41 | 69 | 69 |
| Income before income taxes | 123 | 5,471 | 1,358 | 7,332 |
| Income tax expense | 186 | 2,039 | 739 | 2,772 |
| Net income (loss) | (63) | 3,432 | 619 | 4,560 |
| Net income attributable to non-controlling interest | 75 | 59 | 74 | 99 |
| Net income (loss) attributable to Potbelly Corporation | \$(138) | \$3,373 | \$545 | \$4,461 |
| Net income (loss) per common share attributable to common | | | | |
| stockholders: | | | | |
| Basic | \$(0.01) | \$0.13 | \$0.02 | \$0.17 |
| Diluted | \$(0.01) | \$0.13 | \$0.02 | \$0.17 |
| Weighted average shares outstanding: | | | | |
| Basic | 25,033,868 | 25,818,571 | 25,066,374 | 26,039,082 |
| Diluted | 25,033,868 | 26,459,087 | 25,981,051 | 26,597,012 |

See accompanying notes to the unaudited condensed consolidated financial statements.

Potbelly Corporation and Subsidiaries

Condensed Consolidated Statements of Equity

(amounts in thousands, except share data, unaudited)

| | Common Stock Shares | Common Stock Amount | Treasury Stock | Warrants | Additional Paid-In- Capital | Accumulated Deficit | Non- Controlling Interest | Total Equity |
|--------------------------------------------------------------------------------|------------------------|------------------------|-------------------|----------|-----------------------------------|------------------------|---------------------------------|--------------|
| Balance at December 27, 2015 | 26,304,261 | \$ 303 | \$(50,000) | \$ 909 | \$ 399,458 | \$(221,246) | \$ 789 | \$ 130,213 |
| Net income | — | — | — | — | — | 4,461 | 99 | 4,560 |
| Stock-based compensation | | | | | | | | |
| plans | 322,125 | 3 | — | — | 3,645 | — | — | 3,648 |
| Excess tax benefits associated with exercise of stock options | — | — | — | — | 16 | — | — | 16 |
| Repurchases of common stock | (1,268,844) | — | (16,622) | — | — | — | — | (16,622) |
| Distributions to non- controlling interest | — | — | — | — | — | — | (159) | (159) |
| Amortization of stock-based compensation | — | — | — | — | 1,466 | — | — | 1,466 |
| Balance at June 26, 2016 | 25,357,542 | \$ 306 | \$(66,622) | \$ 909 | \$ 404,585 | \$(216,785) | \$ 729 | \$ 123,122 |
| Balance at December 25, 2016 | 25,139,127 | \$ 309 | \$(72,321) | \$ 909 | \$ 407,622 | \$(213,034) | \$ 751 | \$ 124,236 |
| Net income | — | — | — | — | — | 545 | 74 | 619 |
| Stock-based compensation | | | | | | | | |
| plans | 158,235 | 2 | — | — | 1,113 | — | — | 1,115 |
| Exercise of stock warrants | 241,704 | 2 | — | (909) | 2,879 | — | — | 1,972 |
| Repurchases of common stock | (413,584) | — | (4,996) | — | — | — | — | (4,996) |

Distributions to non-

| | | | | | | | | |
|----------------------|---|---|---|---|---|---|--------|--------|
| controlling interest | — | — | — | — | — | — | (113) | (113) |
|----------------------|---|---|---|---|---|---|--------|--------|

Contributions from non-

| | | | | | | | | |
|----------------------|---|---|---|---|---|---|----|----|
| controlling interest | — | — | — | — | — | — | 11 | 11 |
|----------------------|---|---|---|---|---|---|----|----|

Amortization of

| | | | | | | | | |
|--------------------------|---|---|---|---|-------|---|---|-------|
| stock-based compensation | — | — | — | — | 1,925 | — | — | 1,925 |
|--------------------------|---|---|---|---|-------|---|---|-------|

Balance at June 25,

| | | | | | | | | |
|------|------------|--------|------------|------|------------|--------------|--------|------------|
| 2017 | 25,125,482 | \$ 313 | \$(77,317) | \$ — | \$ 413,539 | \$(212,489) | \$ 723 | \$ 124,769 |
|------|------------|--------|------------|------|------------|--------------|--------|------------|

See accompanying notes to the unaudited condensed consolidated financial statements.

Potbelly Corporation and Subsidiaries

Condensed Consolidated Statements of Cash Flows

(amounts in thousands, unaudited)

| | For the 26 Weeks Ended | |
|------------------------------------------------------------------------------------------|------------------------|---------------|
| | June 25, 2017 | June 26, 2016 |
| Cash flows from operating activities: | | |
| Net income | \$619 | \$4,560 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 12,645 | 11,340 |
| Deferred income tax | 974 | 293 |
| Deferred rent and landlord allowances | 1,097 | 579 |
| Amortization of stock compensation expense | 1,925 | 1,466 |
| Excess tax deficiency (benefit) from stock-based compensation | 89 | (16) |
| Asset impairment, store closure and disposal of property and equipment | 4,262 | 1,028 |
| Amortization of debt issuance costs | 18 | 16 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | (1,789) | (93) |
| Inventories | 43 | 138 |
| Prepaid expenses and other assets | (1,376) | 4,616 |
| Accounts payable | 554 | (1,511) |
| Accrued and other liabilities | (3,921) | 1,737 |
| Net cash provided by operating activities | 15,140 | 24,153 |
| Cash flows from investing activities: | | |
| Acquisition of franchise shop | — | (1,108) |
| Purchases of property and equipment | (15,326) | (12,178) |
| Net cash used in investing activities | (15,326) | (13,286) |
| Cash flows from financing activities: | | |
| Proceeds from exercise of stock options | 1,115 | 3,813 |
| Proceeds from exercise of stock warrants | 1,972 | — |
| Treasury stock repurchases | (4,996) | (16,622) |
| Excess tax benefit from stock-based compensation | — | 16 |
| Contributions from non-controlling interest | 11 | — |
| Distribution to non-controlling interest | (113) | (159) |
| Net cash used in financing activities | (2,011) | (12,952) |
| Net decrease in cash and cash equivalents | (2,197) | (2,085) |
| Cash and cash equivalents at beginning of period | 23,379 | 32,006 |
| Cash and cash equivalents at end of period | \$21,182 | \$29,921 |
| Supplemental cash flow information: | | |
| Income taxes paid | \$3,253 | \$714 |
| Interest paid | 53 | 57 |

Supplemental non-cash investing and financing activities:

| | | |
|----------------------------------------------------------|---------|---------|
| Unpaid liability for purchases of property and equipment | \$2,397 | \$1,580 |
|----------------------------------------------------------|---------|---------|

See accompanying notes to the unaudited condensed consolidated financial statements

Potbelly Corporation and Subsidiaries

Notes to Unaudited Condensed Consolidated Financial Statements (unaudited)

(1) Organization and Other Matters

Business

Potbelly Corporation (the “Company” or “Potbelly”), through its wholly-owned subsidiaries, operates or franchises Potbelly Sandwich Shops in 31 states and the District of Columbia. The Company also sells and administers franchises of Potbelly Sandwich Shops. The first domestic franchise location administered by the Company opened during February 2011. Additionally, in February 2011, the Company opened its first international franchise in the Middle East. In July 2015, the Company opened its first franchise shop in the United Kingdom and in October 2016, the Company opened its first franchise shop in Canada. Additionally, during April 2016, the Company transitioned a franchise shop to a company-operated shop for a purchase price of \$1.1 million. The Company recorded \$0.8 million of goodwill related to the transaction. The Company believes this acquisition is immaterial.

Basis of Presentation

The unaudited condensed consolidated financial statements and notes herein should be read in conjunction with the audited consolidated financial statements of Potbelly Corporation and its subsidiaries and the notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 25, 2016. The unaudited condensed consolidated financial statements included herein have been prepared by the Company without audit, pursuant to the rules and regulations of the U.S. Securities and Exchange Commission’s (the “SEC”) regarding interim financial reporting. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America (“U.S. GAAP”) have been condensed or omitted pursuant to the SEC rules and regulations. In the opinion of management, all adjustments, which are of a normal and recurring nature (except as otherwise noted), that are necessary to present fairly the Company’s financial position as of June 25, 2017 and December 25, 2016, its statement of operations for the 13 and 26 weeks ended June 25, 2017 and June 26, 2016 and its statement of cash flows for the 26 weeks ended June 25, 2017 and June 26, 2016 have been included. The consolidated statements of operations for the interim periods presented herein are not necessarily indicative of the results to be expected for the full year.

The Company does not have any components of other comprehensive income recorded within its consolidated financial statements and therefore, does not separately present a statement of comprehensive income in its condensed consolidated financial statements.

Principles of Consolidation

The unaudited condensed consolidated financial statements include the accounts of Potbelly Corporation; its wholly owned subsidiary, Potbelly Illinois, Inc. (“PII”); PII’s wholly owned subsidiaries, Potbelly Franchising, LLC and Potbelly Sandwich Works, LLC (“LLC”); eight of LLC’s wholly owned subsidiaries and LLC’s five joint ventures, collectively, the “Company.” All significant intercompany balances and transactions have been eliminated in consolidation. For consolidated joint ventures, non-controlling interest represents a non-controlling partner’s share of the assets, liabilities and operations related to the five joint venture investments. The Company has ownership interests ranging from 51-80% in these consolidated joint ventures.

Fiscal Year

The Company uses a 52/53-week fiscal year that ends on the last Sunday of the calendar period. Approximately every five or six years a 53rd week is added. Fiscal year 2017 consists of 53 weeks and 2016 consisted of 52 weeks. The fiscal quarters ended June 25, 2017 and June 26, 2016 each consisted of 13 weeks.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Significant estimates include amounts for long-lived assets and income taxes. Actual results could differ from those estimates.

New and Revised Financial Accounting Standards

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, "Revenue from Contracts with Customers." The pronouncement was issued to clarify the principles for recognizing revenue and to develop a common revenue standard and disclosure requirements for U.S. GAAP and International Financial Reporting Standards (IFRS). The FASB approved a one-year deferral of the effective date of ASU 2014-09, such that it will become effective for the annual period beginning after December 15, 2017. In addition, the FASB issued ASU 2016-08, ASU 2016-10 and ASU 2016-12 in March 2016, April 2016 and May 2016, respectively, to help provide interpretive clarifications on the new guidance in Accounting Standards Codification (ASC) Topic 606. Potbelly will adopt the standard effective the first quarter of 2018 and apply the amendments using the modified retrospective method. Based on a preliminary assessment, the Company has determined that the adoption will not have a material impact on sandwich shop sales, but may impact franchise revenue and gift card breakage. The Company is continuing its assessment, which may identify additional impacts this standard will have on its consolidated financial statements and related disclosures.

In February 2016, the FASB issued ASU No. 2016-02, "Leases," which will replace the existing guidance in ASC 840, "Leases." The pronouncement requires a dual approach for lessee accounting under which a lessee would account for leases as finance leases or operating leases. Both finance leases and operating leases will result in the lessee recognizing a right-of-use asset and a corresponding lease liability. For finance leases, the lessee would recognize interest expense and amortization of the right-of-use asset and for operating leases, the lessee would recognize a straight-line total lease expense. The pronouncement is effective for fiscal years beginning after December 15, 2018, including annual and interim periods thereafter. In addition, the pronouncement requires the use of the modified retrospective method, which will require adjustment to all comparative periods presented in the consolidated financial statements. The Company is currently evaluating the impact ASU 2016-02 will have on its financial position, results of operations and cash flows but expects that it will result in a material increase in its long-term assets and liabilities given the Company has a significant number of leases.

In March 2016, the FASB issued ASU No. 2016-09, "Compensation – Stock Compensation (Topic 718)." The pronouncement simplifies the accounting for the taxes related to stock-based compensation, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification within the statement of cash flows. The pronouncement is effective for annual periods beginning after December 15, 2016, including annual and interim periods thereafter. Potbelly adopted ASU 2016-09 in the first quarter of 2017. The primary impact of adoption was the recognition of excess tax benefits and deficiencies that arise upon vesting or exercise of share-based payments in the Income Statement as income tax expense instead of a component of equity recorded to paid-in capital. This aspect of the new guidance, which was required to be adopted prospectively, resulted in an additional income tax expense of \$158 thousand and \$247 thousand for the 13 weeks and 26 weeks ended June 25, 2017, respectively. Potbelly has elected to continue to estimate forfeitures expected to occur to determine the amount of compensation cost to be recognized in each period. Excess income tax benefits and deficiencies from stock-based compensation arrangements are now classified as cash flow from operations, instead of as cash flow used in financing activities. The Company elected to apply this change in presentation prospectively and as such prior periods have not been adjusted. Additionally, in accordance with the new standard, the Company now excludes excess tax benefits and deficiencies from the assumed proceeds available to repurchase shares in the computation of the Company's diluted earnings per share.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350).” The new standard eliminates step 2 from the goodwill impairment test. Instead, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss will be recognized in an amount equal to that excess. Under current U.S. GAAP, to perform step 2 an entity must determine its implied fair value, which is determined in the same manner as the amount of goodwill recognized in a business combination. In addition to eliminating step 2, the new standard eliminates the requirement for a reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform step 2 of the goodwill impairment test. Instead, all reporting units, even those with a zero or negative amount will apply the same impairment test. An entity is required to disclose the amount of goodwill allocated to each reporting unit with a zero or negative carrying amount of net assets. The standard will be effective for Potbelly in the fiscal year beginning after December 15, 2019. Early adoption for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017 is permitted. This amendment is required to be applied on a prospective basis. Potbelly is currently assessing the impact and timing of adopting this guidance on its consolidated financial statements.

(2) Fair Value Measurement

The carrying amounts of cash and cash equivalents, accounts receivable, accounts payable and all other current liabilities approximate fair values due to the short maturities of these balances.

The Company assesses potential impairments to its long-lived assets, which includes property and equipment, on a quarterly basis or whenever events or circumstances indicate that the carrying amount of an asset may not be recoverable. Shop-level assets are grouped at the individual shop-level for the purpose of the impairment assessment. Recoverability of an asset is measured by a comparison of the carrying amount of an asset to its estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of the asset group exceeds its estimated undiscounted future cash flows, an impairment charge is recognized as the amount by which the carrying amount of the asset exceeds the fair value of the asset. The fair value of the shop assets was determined using the discounted future cash flow method of anticipated cash flows through the shop's lease-end date using fair value measurement inputs classified as Level 3. Level 3 inputs are derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable. After performing a periodic review of the Company's shops during the 13 weeks and 26 weeks ended June 25, 2017, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance. The Company performed an impairment analysis related to these shops and recorded an impairment charge of \$3.3 million and \$4.2 million for the 13 and 26 weeks ended June 25, 2017, respectively. The company recorded an impairment charge of \$1.0 million for the 13 and 26 weeks ended June 26, 2016.

(3) Earnings (Loss) Per Share

Basic and diluted income per common share attributable to common stockholders was calculated using the weighted average number of common shares outstanding for the period. Diluted income per common share attributable to common stockholders is computed by dividing the income allocated to common stockholders by the weighted average number of fully diluted common shares outstanding. In periods of a net loss, no potential common shares are included in diluted shares outstanding as the effect is anti-dilutive. For the 13 weeks ended June 25, 2017, the Company had a loss per share, therefore, shares were excluded for potential stock option exercises and warrant exercises.

The following table summarizes the earnings per share calculation:

| | For the 13 Weeks Ended | | For the 26 Weeks Ended | |
|------------------------------------------------------------------|------------------------|------------------|------------------------|------------------|
| | June 25, 2017 | June 26, 2016 | June 25, 2017 | June 26, 2016 |
| Net income (loss) attributable to Potbelly Corporation | \$(138) | \$3,373 | \$545 | \$4,461 |
| Weighted average common shares outstanding-basic | 25,033,868 | 25,818,571 | 25,066,374 | 26,039,082 |
| Plus: Effect of potential stock options exercise | — | 581,971 | 831,927 | 504,761 |
| Plus: Effect of potential warrant exercise | — | 58,545 | 82,750 | 53,169 |
| Weighted average common shares outstanding-diluted | 25,033,868 | 26,459,087 | 25,981,051 | 26,597,012 |
| Income (loss) per share available to common stockholders-basic | \$(0.01) | \$0.13 | \$0.02 | \$0.17 |
| Income (loss) per share available to common stockholders-diluted | \$(0.01) | \$0.13 | \$0.02 | \$0.17 |
| Potentially dilutive shares that are considered anti-dilutive: | | | | |
| Common share options | 4,030,128 | 1,003,718 | 1,109,681 | 1,238,252 |

(4) Income Taxes

The Company recognized income tax expense of \$0.2 million on pre-tax income of \$0.1 million, or an effective tax rate of 151.2%, for the 13 weeks ended June 25, 2017, compared to income tax expense of \$2.0 million on pre-tax income of \$5.5 million, or an effective tax rate of 37.3%, for the 13 weeks ended June 26, 2016. The Company recognized income tax expense of \$0.7 million on pre-tax income of \$1.4 million, or an effective tax rate of 54.4%, for the 26 weeks ended June 25, 2017, compared to income tax expense of \$2.8 million on pre-tax income of \$7.3 million, or an effective tax rate of 37.8%, for the 26 weeks ended June 26, 2016. The effective tax rate was above the federal statutory rate primarily due to the adoption of ASU 2016-09, which increased the Company's tax rate by 129.5% for the 13 weeks ended June 26, 2017 and 18.2% for the 26 weeks ended June 26, 2017 and state income taxes. These increases were partially offset by certain federal and state tax credits. See Note 1 for additional information regarding the adoption of ASU 2016-09.

(5) Capital Stock

On September 8, 2016, the Company announced that its Board of Directors authorized a share repurchase program of up to \$30.0 million of the Company's common stock. The Company's previous \$35.0 million share repurchase program, authorized in September 2015, was completed in July 2016. The current program permits the Company, from time to time, to purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Securities Exchange Act of 1934, as amended) or in privately negotiated transactions. During the 26 weeks ended June 25, 2017, the Company repurchased 413,584 shares of its common stock for approximately \$5.0 million, including cost and commission, in open market transactions. As of June 25, 2017, the remaining dollar value of authorization under the share repurchase program was \$22.7 million, which does not include commission. Repurchased shares are included as treasury stock in the condensed consolidated balance sheets and the condensed consolidated statements of equity.

(6) Stock-Based Compensation

Stock options are awarded under the 2013 Long-Term Incentive Plan to eligible employees. The fair value of stock options is determined using the Black-Scholes option pricing model. The weighted average fair value of options granted during the 26 weeks ended June 25, 2017 was \$4.58 per share, as estimated using the following weighted average assumptions: expected life of options – 6.25 years; volatility – 36.37%; risk-free interest rate – 2.23%; and dividend yield – 0.0%. The Company used the simplified method for determining the expected life of the options. The expected volatility of the options was calculated using the Company's historical data.

A summary of activity for the 26 weeks ended June 25, 2017 is as follows:

| | Shares | Weighted Average Exercise Price | Aggregate Intrinsic Value (Thousands) | Weighted Average Remaining Term (Years) |
|---------------------------------------|--------|------------------------------------------|------------------------------------------------|-----------------------------------------------------|
| Options Outstanding—December 25, 2016 | 4,013 | \$ 10.61 | \$ 13,455 | 4.78 |
| Granted | 263 | 11.55 | | |
| Exercised | (117) | 9.57 | | |
| Canceled | (54) | 14.98 | | |
| Options Outstanding—June 25, 2017 | 4,105 | \$ 10.64 | \$ 7,425 | 4.69 |
| Exercisable—June 25, 2017 | 3,124 | \$ 9.94 | \$ 7,140 | 3.56 |

Stock-based compensation is measured at the grant date, based on the calculated fair value of the award and is recognized as expense over the requisite employee service period, which is generally the vesting period of the grant,

with a corresponding increase to additional paid-in-capital. For the 13 and 26 weeks ended June 25, 2017, the Company recognized stock-based compensation expense of \$1.1 million and \$1.9 million, respectively. \$0.2 million of the stock-based compensation expense was related to Chief Executive Officer (CEO) transition costs. For the 13 and 26 weeks ended June 26, 2016, the Company recognized stock-based compensation of \$0.8 million and \$1.5 million, respectively. As of June 25, 2017, unrecognized stock-based compensation expense was \$6.4 million, which will be recognized through fiscal year 2021. The Company records stock-based compensation expense within general and administrative expenses in the condensed consolidated statements of operations.

In May 2017, the Company issued 153,369 shares of restricted stock units (“RSUs”) to certain non-employee members of its Board of Directors and the senior leadership team. The RSUs had a grant-date fair value of \$11.05 upon issuance. The Board of Director grants have a vesting schedule of 50% on the first anniversary of the grant date and 50% on the second anniversary of the grant date. The senior leadership team grants vest in one-third increments over a three-year period beginning in March 2018. In May 2016, the Company issued 52,558 shares of RSUs to certain non-employee members of its Board of Directors. The RSUs had a grant-date fair value of \$13.27 upon issuance and have a vesting schedule of 50% on the first anniversary of the grant date and 50% on the second anniversary of the grant date.

(7) Commitments and Contingencies

In 2016, the Company received notice of a potential claim alleging that it violated the Fair Labor Standards Act by not paying overtime to its assistant managers, whom the Company had classified as exempt employees. Although the Company believes that its assistant managers were properly classified as exempt under both federal and state laws, the Company agreed to mediate the matter. On February 20, 2017, the parties entered into a Settlement Agreement and Release whereby participating assistant managers agreed to release the Company from all federal and/or state wage and hour claims in exchange for a gross settlement amount of \$1.3 million. As part of the settlement process, a complaint was filed on February 17, 2017 in the Circuit Court of the Fifteenth Judicial Circuit in and for Palm Beach County, Florida. A motion seeking the Court's approval of the settlement was filed on February 21, 2017, which was subsequently approved. In March 2017, the Company paid out the settlement, which was booked against the previously recorded liability.

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

Forward-Looking Statements

The following discussion of our financial condition and results of operations should be read in conjunction with the unaudited condensed consolidated financial statements and the notes thereto included elsewhere in this Quarterly Report on Form 10-Q and with our audited consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended December 25, 2016. This discussion contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and involves numerous risks and uncertainties. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts and generally contain words such as "believes," "expects," "may," "will," "should," "seeks," "intends," "plans," "strives," "goals," "forecasts," "projects" or "anticipates" or similar expressions. Our forward-looking statements are subject to risks and uncertainties, which may cause actual results to differ materially from those projected or implied by the forward-looking statement. Forward-looking statements are based on current expectations and assumptions and currently available data and are neither predictions nor guarantees of future events or performance. You should not place undue reliance on forward-looking statements, which speak only as of the date hereof. See "Risk Factors" and "Cautionary Note Regarding Forward-Looking Statements" included in our Annual Report on Form 10-K for the fiscal year ended December 25, 2016, for a discussion of factors that could cause our actual results to differ from those expressed or implied by forward-looking statements.

Overview

Potbelly Corporation (the "Company" or "Potbelly") is a fast-growing neighborhood sandwich concept offering toasty warm sandwiches, signature salads and other fresh menu items served by engaging people in an environment that reflects the Potbelly brand. Our combination of product, people and place is how we deliver on our passion to be "The Best Place for Lunch." Our sandwiches, salads and hand-dipped milkshakes are all made fresh to order and our cookies are baked fresh each day. Our employees are trained to engage with our customers in a genuine way to provide a personalized experience. Our shops feature vintage design elements and locally-themed décor inspired by the neighborhood that we believe create a lively atmosphere. Through this combination, we believe we are creating a devoted base of Potbelly fans that return again and again and that we are expanding one sandwich shop at a time.

We believe that a key to our past and future success is our culture. It is embodied in The Potbelly Advantage, which is an expression of our Vision, Mission, Passion and Values and the foundation of everything we do. Our Vision is for our customers to feel that we are their "Neighborhood Sandwich Shop" and to tell others about their great experience. Our Mission is to make people really happy, to make more money and to improve every day. Our Passion is to be "The Best Place for Lunch." Our Values embody both how we lead and how we behave and form the cornerstone of our culture. We use simple language that resonates from the frontline associate to the most senior levels of the organization, creating shared expectations and accountabilities in how we approach our day-to-day activities. We strive to be a fun, friendly and hardworking group of people who enjoy taking care of our customers, while at the same time taking care of each other.

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The table below sets forth a rollforward of company-operated and franchise operated activities:

| | Company- Operated | Franchise-Operated Domestic | International | Total | Total Company |
|---------------------------------|----------------------|--------------------------------|---------------|-------|------------------|
| Shops as of December 27, 2015 | 372 | 24 | 12 | 36 | 408 |
| Shops opened | 9 | 4 | 1 | 5 | 14 |
| Shops purchased from franchisee | 1 | (1) | — | (1) | — |
| Shops closed | — | — | (1) | (1) | (1) |
| Shops as of June 26, 2016 | 382 | 27 | 12 | 39 | 421 |
| Shops as of December 25, 2016 | 411 | 30 | 13 | 43 | 454 |
| Shops opened | 16 | 8 | 3 | 11 | 27 |
| Shops closed | (3) | — | — | — | (3) |
| Shops as of June 25, 2017 | 424 | 38 | 16 | 54 | 478 |

13 Weeks Ended June 25, 2017 Compared to 13 Weeks Ended June 26, 2016

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

| | For the 13 Weeks Ended | | | | Increase (Decrease) | Percent Change |
|--------------------------------------------|------------------------|------------------|------------------|------------------|------------------------|-------------------|
| | June 25, 2017 | % of Revenues | June 26, 2016 | % of Revenues | | |
| Revenues | | | | | | |
| Sandwich shop sales, net | \$ 107,382 | 99.3 % | \$ 104,466 | 99.5 % | \$ 2,916 | 2.8 % |
| Franchise royalties and fees | 754 | 0.7 | 570 | 0.5 | 184 | 32.3 |
| Total revenues | 108,136 | 100.0 | 105,036 | 100.0 | 3,100 | 3.0 |
| Expenses | | | | | | |
| Sandwich shop operating expenses | | | | | | |
| Cost of goods sold, excluding | | | | | | |
| depreciation | 28,635 | 26.5 | 28,500 | 27.1 | 135 | 0.5 |
| Labor and related expenses | 31,564 | 29.2 | 29,935 | 28.5 | 1,629 | 5.4 |
| Occupancy expenses | 14,269 | 13.2 | 13,174 | 12.5 | 1,095 | 8.3 |
| Other operating expenses | 12,252 | 11.2 | 10,687 | 10.2 | 1,565 | 14.6 |
| General and administrative expenses | 10,919 | 10.1 | 10,305 | 9.8 | 614 | 6.0 |
| Depreciation expense | 6,446 | 6.0 | 5,676 | 5.4 | 770 | 13.6 |
| Pre-opening costs | 546 | 0.5 | 239 | 0.2 | 307 | >100 |
| Impairment and loss on disposal of | | | | | | |
| property and equipment | 3,341 | 3.1 | 1,008 | 1.0 | 2,333 | >100 |
| Total expenses | 107,972 | 99.8 | 99,524 | 94.8 | 8,448 | 8.5 |
| Income from operations | 164 | 0.2 | 5,512 | 5.2 | (5,348) | (97.0) |
| Interest expense | 41 | * | 41 | * | — | — |
| Income before income taxes | 123 | 0.1 | 5,471 | 5.2 | (5,348) | (97.8) |
| Income tax expense | 186 | 0.2 | 2,039 | 1.9 | (1,853) | (90.9) |
| Net income (loss) | (63) | * | 3,432 | 3.3 | (3,495) | >(100) |
| Net income attributable to non-controlling | | | | | | |
| interest | 75 | * | 59 | * | 16 | 27.1 |
| Net income (loss) attributable to Potbelly | | | | | | |
| Corporation | \$(138) | (0.1)% | \$3,373 | 3.2 % | \$(3,511) | >(100)% |

* Amount was less than 0.1%
Revenues

Total revenues increased by \$3.1 million, or 3.0%, to \$108.1 million during the 13 weeks ended June 25, 2017, from \$105.0 million during the 13 weeks ended June 26, 2016. The revenue growth was driven by an increase in sales of \$9.5 million from shops not yet in our company-operated comparable store sales base and an increase of \$0.2 million from franchise royalties and fees. These increases were partially offset by a decrease in sales of \$5.1 million, or 4.9%, from company-operated comparable store shops and a decline of \$1.6 million from shops that have closed. The decrease in company-operated comparable store sales resulted primarily from a decrease in traffic partially offset by certain menu price increases.

Cost of Goods Sold

Cost of goods sold increased by \$0.1 million, or 0.5%, to \$28.6 million during the 13 weeks ended June 25, 2017, from \$28.5 million during the 13 weeks ended June 26, 2016, primarily due to the increase in revenues. As a percentage of revenues, cost of goods sold decreased to 26.5% during the 13 weeks ended June 25, 2017, from 27.1% during the 13 weeks ended June 26, 2016, primarily driven by certain menu price increases.

Labor and Related Expenses

Labor and related expenses increased by \$1.6 million, or 5.4%, to \$31.6 million during the 13 weeks ended June 25, 2017, from \$29.9 million during the 13 weeks ended June 26, 2016, primarily due to new shop openings and inflationary wage increases in certain states. As a percentage of revenues, labor and related expenses increased to 29.2% during the 13 weeks ended June 25, 2017, from 28.5% during the 13 weeks ended June 26, 2016, primarily driven by a decrease in company-operated comparable store shop revenue and inflationary wage increases in certain states.

Occupancy Expenses

Occupancy expenses increased by \$1.1 million, or 8.3%, to \$14.3 million during the 13 weeks ended June 25, 2017, from \$13.2 million during the 13 weeks ended June 26, 2016, primarily due to new shop openings and an increase in real estate taxes and common area maintenance. As a percentage of revenues, occupancy expenses increased to 13.2% during the 13 weeks ended June 25, 2017, from 12.5% during the 13 weeks ended June 26, 2016, primarily due to a decrease in company-operated comparable store shop revenue and an increase in real estate taxes and common area maintenance.

Other Operating Expenses

Other operating expenses increased by \$1.6 million, or 14.6%, to \$12.3 million during the 13 weeks ended June 25, 2017, from \$10.7 million during the 13 weeks ended June 26, 2016. The increase was attributable to new shop openings as well as higher utility costs and credit card fees. As a percentage of revenues, other operating expenses increased to 11.2% during the 13 weeks ended June 25, 2017, from 10.2% during the 13 weeks ended June 26, 2016, primarily driven by a decrease in company-operated comparable store shop revenue and higher utility expense.

General and Administrative Expenses

General and administrative expenses increased by \$0.6 million, or 6.0%, to \$10.9 million during the 13 weeks ended June 25, 2017, from \$10.3 million during the 13 weeks ended June 26, 2016. The increase was driven primarily by Chief Executive Officer (CEO) transition costs of \$1.0 million. This increase was partially offset by lower performance-based incentive expenses. As a percentage of revenues, general and administrative expenses increased to 10.1% during the 13 weeks ended June 25, 2017, from 9.8% during the 13 weeks ended June 26, 2016, primarily due to CEO transition costs of \$1.0 million. This increase was partially offset by lower performance-based incentive expenses.

Depreciation Expense

Depreciation expense increased by \$0.8 million, or 13.6%, to \$6.4 million during the 13 weeks ended June 25, 2017, from \$5.7 million during the 13 weeks ended June 26, 2016, primarily due to a higher depreciable base related to new

shops and existing shop capital investments. As a percentage of revenues, depreciation increased to 6.0% during the 13 weeks ended June 25, 2017, from 5.4% during the 13 weeks ended June 26, 2016, driven by a decrease in company-operated comparable store shop revenue and a higher depreciable base related to new shops and existing shop capital investments.

Pre-Opening Costs

Pre-opening costs increased by \$0.3 million, or 128.5%, to \$0.5 million during the 13 weeks ended June 25, 2017, from \$0.2 million during the 13 weeks ended June 26, 2016.

Impairment and Loss on Disposal of Property and Equipment

Impairment and loss on disposal of property and equipment increased to \$3.3 million during the 13 weeks ended June 25, 2017, from \$1.0 million during the 13 weeks ended June 26, 2016. After performing periodic reviews of Company shops during the second quarter of 2017, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance. We performed impairment analyses related to these shops and recorded an impairment charge of \$3.3 million for the excess of the carrying amount recorded on our balance sheet over the shops' estimated fair value. We perform impairment analyses on a quarterly basis which involve significant judgment by management including estimates of future cash flows and future growth rates, among other assumptions. Based on our current projections, no impairment, beyond what has already been recorded, has been identified. However, given the current challenges facing the industry and our business, future evaluations could result in additional impairment charges.

Interest Expense

Interest expense was \$41 thousand during the 13 weeks ended June 25, 2017 and June 26, 2016.

Income Tax Expense

Income tax expense decreased by \$1.9 million, or 90.9%, to \$0.2 million for the 13 weeks ended June 25, 2017, from \$2.0 million for the 13 weeks ended June 26, 2016, primarily attributable to changes in pre-tax book income. The decrease was partially offset by the adoption of Accounting Standards Update (ASU) 2016-09, which resulted in the tax effects of equity-based compensation being recorded through the income statement rather than equity. For the 13 weeks ended June 25, 2017, the effective tax rate was 151.2%, compared to 37.3% for the 13 weeks ended June 26, 2016. The increase in the effective tax rate was driven by the net effect of the adoption of ASU 2016-09 for stock-based compensation, which increased our tax rate by 129.5%. See Note 1 to the Condensed Consolidated Financial Statements for additional information regarding the adoption of ASU 2016-09.

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26 Weeks Ended June 25, 2017 Compared to 26 Weeks Ended June 26, 2016

The following table presents information comparing the components of net income for the periods indicated (dollars in thousands):

| | For the 26 Weeks Ended | | | | Increase (Decrease) | Percent Change |
|--------------------------------------------|------------------------|------------------|------------------|------------------|------------------------|-------------------|
| | June 25, 2017 | % of Revenues | June 26, 2016 | % of Revenues | | |
| Revenues | | | | | | |
| Sandwich shop sales, net | \$208,241 | 99.2 | % \$199,892 | 99.5 | % \$ 8,349 | 4.2 |
| Franchise royalties and fees | 1,594 | 0.8 | 1,099 | 0.5 | 495 | 45.0 |
| Total revenues | 209,835 | 100.0 | 200,991 | 100.0 | 8,844 | 4.4 |
| Expenses | | | | | | |
| Sandwich shop operating expenses | | | | | | |
| Cost of goods sold, excluding | | | | | | |
| depreciation | 55,298 | 26.4 | 54,746 | 27.2 | 552 | 1.0 |
| Labor and related expenses | 62,026 | 29.6 | 58,097 | 28.9 | 3,929 | 6.8 |
| Occupancy expenses | 28,438 | 13.6 | 25,931 | 12.9 | 2,507 | 9.7 |
| Other operating expenses | 23,885 | 11.3 | 21,232 | 10.6 | 2,653 | 12.5 |
| General and administrative expenses | | | | | | |
| Depreciation expense | 12,645 | 6.0 | 11,340 | 5.6 | 1,305 | 11.5 |
| Pre-opening costs | 619 | 0.3 | 391 | 0.2 | 228 | 58.3 |
| Impairment and loss on disposal | | | | | | |
| of property and equipment | 4,226 | 2.0 | 1,025 | 0.5 | 3,201 | >100 |
| Total expenses | 208,408 | 99.3 | 193,590 | 96.3 | 14,818 | 7.7 |
| Income from operations | 1,427 | 0.7 | 7,401 | 3.7 | (5,974) | (80.7) |
| Interest expense | 69 | * | 69 | * | — | — |
| Income before income taxes | 1,358 | 0.6 | 7,332 | 3.6 | (5,974) | (81.5) |
| Income tax expense | 739 | 0.4 | 2,772 | 1.4 | (2,033) | (73.3) |
| Net income | 619 | 0.3 | 4,560 | 2.3 | (3,941) | (86.4) |
| Net income attributable to non- | | | | | | |
| controlling interests | 74 | * | 99 | * | (25) | (25.3) |
| Net income attributable to | | | | | | |
| Potbelly Corporation | \$545 | 0.3 | % \$4,461 | 2.2 | % \$(3,916) | (87.8)% |

* Amount was less than 0.1%

Revenues

Total revenues increased by \$8.8 million, or 4.4%, to \$209.8 million during the 26 weeks ended June 25, 2017, from \$201.0 million during the 26 weeks ended June 26, 2016. The revenue growth was driven by an increase in sales of \$18.1 million from shops not yet in our company-operated comparable store sales base and an increase of \$0.5 million from franchise royalties and fees. These increases were partially offset by a decrease in sales of \$7.9 million, or 4.0%, from company-operated comparable store shops and a decline of \$1.9 million from shops that have closed. The decrease in company-operated comparable store sales resulted primarily from a decrease in traffic partially offset by certain menu price increases.

Cost of Goods Sold

Cost of goods sold increased by \$0.6 million, or 1.0%, to \$55.3 million during the 26 weeks ended June 25, 2017, from \$54.7 million during the 26 weeks ended June 26, 2016, primarily due to the increase in revenues. As a percentage of revenues, cost of goods sold decreased to 26.4% during the 26 weeks ended June 25, 2017, from 27.2% during the 26 weeks ended June 26, 2016, primarily driven by certain menu price increases.

Labor and Related Expenses

Labor and related expenses increased by \$3.9 million, or 6.8%, to \$62.0 million during the 26 weeks ended June 25, 2017, from \$58.1 million during the 26 weeks ended June 26, 2016, primarily due to new shop openings and inflationary wage increases in certain states. As a percentage of revenues, labor and related expenses increased to 29.6% during the 26 weeks ended June 25, 2017, from 28.9% during the 26 weeks ended June 26, 2016, primarily driven by a decrease in company-operated comparable store shop revenue and inflationary wage increases in certain states.

Occupancy Expenses

Occupancy expenses increased by \$2.5 million, or 9.7%, to \$28.4 million during the 26 weeks ended June 25, 2017, from \$25.9 million during the 26 weeks ended June 26, 2016, primarily due to new shop openings and an increase in real estate taxes and common area maintenance. As a percentage of revenues, occupancy expenses increased to 13.6% during the 26 weeks ended June 25, 2017, from 12.9% during the 26 weeks ended June 26, 2016, primarily due to a decrease in company-operated comparable store shop revenue and an increase in real estate taxes and common area maintenance.

Other Operating Expenses

Other operating expenses increased by \$2.7 million, or 12.5%, to \$23.9 million during the 26 weeks ended June 25, 2017, from \$21.2 million during the 26 weeks ended June 26, 2016. The increase was attributable to new shop openings as well as higher utility costs and credit card fees. As a percentage of revenues, other operating expenses increased to 11.3% during the 26 weeks ended June 25, 2017, from 10.6% during the 26 weeks ended June 26, 2016, primarily driven by a decrease in company-operated comparable store shop revenue and higher utility expense.

General and Administrative Expenses

General and administrative expenses increased by \$0.4 million, or 2.1%, to \$21.3 million during the 26 weeks ended June 25, 2017, from \$20.8 million during the 26 weeks ended June 26, 2016. The increase was driven primarily by CEO transition costs of \$1.0 million. This increase was partially offset by lower performance-based incentive expenses. As a percentage of revenues, general and administrative expenses decreased to 10.1% during the 26 weeks ended June 25, 2017, from 10.4% during the 26 weeks ended June 26, 2016, primarily due to lower performance-based incentive expenses. This decrease was partially offset by CEO transition costs of \$1.0 million.

Depreciation Expense

Depreciation expense increased by \$1.3 million, or 11.5%, to \$12.6 million during the 26 weeks ended June 25, 2017, from \$11.3 million during the 26 weeks ended June 26, 2016, primarily due to a higher depreciable base related to new shops and existing shop capital investments. As a percentage of revenues, depreciation increased to 6.0% during the 26 weeks ended June 25, 2017, from 5.6% during the 26 weeks ended June 26, 2016, driven by a decrease in company-operated comparable store shop revenue and a higher depreciable base related to new shops and existing shop capital investments.

Pre-Opening Costs

Pre-opening costs increased by \$0.2 million, or 58.3%, to \$0.6 million during the 26 weeks ended June 25, 2017, from \$0.4 million during the 26 weeks ended June 26, 2016.

Impairment and Loss on Disposal of Property and Equipment

Impairment and loss on disposal of property and equipment increased to \$4.2 million during the 26 weeks ended June 25, 2017, compared to \$1.0 million during the 26 weeks ended June 26, 2016. After performing periodic reviews of Company shops during the first and second quarter of 2017, it was determined that indicators of impairment were present for certain shops as a result of continued underperformance. We performed impairment analyses related to these shops and recorded impairment charges of \$4.2 million for the excess of the carrying amount recorded on our balance sheet over the shops' estimated fair value. We perform impairment analyses on a quarterly basis which involve significant judgment by management including estimates of future cash flows and future growth rates, among other assumptions. Based on our current projections, no impairment, beyond what has already been recorded, has been identified. However, given the current challenges facing the industry and our business, future evaluations could result in additional impairment charges.

Interest Expense

Interest expense was \$69 thousand during the 26 weeks ended June 25, 2017 and June 26, 2016.

Income Tax Expense

Income tax expense decreased by \$2.0 million, or 73.3%, to \$0.7 million for the 26 weeks ended June 25, 2017, from \$2.8 million for the 26 weeks ended June 26, 2016, primarily attributable to changes in pre-tax book income. The decrease was partially offset by the adoption of ASU 2016-09, which resulted in the tax effects of equity-based compensation being recorded through the income statement rather than equity. For the 26 weeks ended June 25, 2017, the effective tax rate was 54.4%, compared to 37.8% for the 26 weeks ended June 26, 2016. The increase in the effective tax rate was primarily driven by the net effect of the adoption of ASU 2016-09 for stock-based compensation, which increased our tax rate by approximately 18.2%. See Note 1 to the Condensed Consolidated Financial Statements for additional information regarding the adoption of ASU 2016-09.

Liquidity and Capital Resources

General

Our ongoing primary sources of liquidity and capital resources are cash provided from operating activities, existing cash and cash equivalents and our credit facility. Our primary requirements for liquidity and capital are new shop openings, existing shop capital investments (maintenance and improvements), repurchases of our common stock, lease obligations, purchases of existing franchise-operated shops and general corporate needs. Our requirement for working capital is not significant since our customers pay for their food and beverage purchases in cash or payment cards (credit or debit) at the time of sale. Therefore, we are able to sell certain inventory items before we have to pay our suppliers. Our shops do not require significant inventories or receivables. We believe that these sources of liquidity and capital will be sufficient to finance our continued operations and expansion plans for at least the next twelve months.

The following table presents summary cash flow information for the periods indicated (in thousands):

| | For the 26 Weeks Ended | |
|---------------------------------|---------------------------|------------------|
| | June 25, 2017 | June 26, 2016 |
| Net cash provided by (used in): | | |
| Operating activities | \$15,140 | \$24,153 |
| Investing activities | (15,326) | (13,286) |
| Financing activities | (2,011) | (12,952) |
| Net decrease in cash | \$(2,197) | \$(2,085) |

Operating Activities

Net cash provided by operating activities decreased to \$15.1 million for the 26 weeks ended June 25, 2017, from \$24.2 million for the 26 weeks ended June 26, 2016. The \$9.1 million decrease was primarily attributable to a decrease of \$3.9 million in net income. The remainder of the decrease was primarily driven by changes in certain working capital accounts mainly due to timing.

Investing Activities

Net cash used in investing activities increased to \$15.3 million for the 26 weeks ended June 25, 2017, from \$13.3 million for the 26 weeks ended June 26, 2016. The increase was primarily due to construction costs for new company-operated shops opened for the 26 weeks ended June 25, 2017, compared to new company-operated shops opened for the 26 weeks ended June 26, 2016, as well as capital expenditures for future shop openings, maintaining our existing shops and certain other projects.

Financing Activities

Net cash used in financing activities decreased to \$2.0 million for the 26 weeks ended June 25, 2017, from \$13.0 million for the 26 weeks ended June 26, 2016. The decrease in net cash used was primarily driven by \$5.0 million of treasury stock repurchased during the 26 weeks ended June 25, 2017, compared to \$16.6 million during the 26 weeks ended June 26, 2016. Additionally, Potbelly received \$3.1 million in proceeds from the exercise of stock options and warrants during the 26 weeks ended June 25, 2017 compared to \$3.8 million during the 26 weeks ended June 26, 2016.

Stock Repurchase Program

On September 8, 2016, the Company announced that its Board of Directors authorized a share repurchase program of up to \$30.0 million of the Company's common stock. The Company's previous \$35.0 million share repurchase program, authorized in September 2015, was completed in July 2016. The current program permits the Company, from time to time, to purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Exchange Act of 1934, as amended) or in privately negotiated transactions. During the 26 weeks ended June 25, 2017, the Company repurchased 413,584 shares of our common stock for approximately \$5.0 million, including cost and commission, in open market transactions. As of June 25, 2017, the remaining dollar value of authorization under the share repurchase program was \$22.7 million, which does not include commission. Repurchased shares are included as treasury stock in the condensed consolidated balance sheets and the condensed consolidated statements of equity.

Credit Facility

On December 9, 2015, we entered into an amended and restated five-year revolving credit facility agreement that expires in November 2020. The credit agreement provides, among other things, for a revolving credit facility in a maximum principal amount of \$50.0 million, with possible future increases to \$75.0 million under an expansion feature. Borrowings under the credit facility generally bear interest at our option at either (i) a eurocurrency rate determined by reference to the applicable London Interbank Offered Rate (LIBOR) plus a margin ranging from 1.00% to 1.75% or (ii) a prime rate as announced by JP Morgan Chase plus a margin ranging from 0.00% to 0.50%. The applicable margin is determined based upon our consolidated total leverage ratio. On the last day of each calendar quarter, we are required to pay a commitment fee ranging from 0.125% to 0.20% per annum in respect of any unused commitments under the credit facility, with the specific rate determined based upon our consolidated total leverage ratio. So long as the leverage ratios are met, there is no limit on the "restricted payments" (primarily distributions and equity repurchases) that we may make. As of June 25, 2017, we had no amounts outstanding under the credit facility.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with U.S. GAAP. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Significant estimates include amounts for long-lived assets and income taxes. Actual results could differ from those estimates. Critical accounting policies are those that management believes are both most important to the portrayal of our financial condition and operating results and require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. We base our estimates on historical experience and other factors that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Judgments and uncertainties affecting the application of those policies may result in materially different amounts being reported under different conditions or using different assumptions. We had no significant changes in our critical accounting estimates since our last annual report. Our critical accounting estimates are identified and described in our annual consolidated financial statements and related notes.

Off-Balance Sheet Arrangements

As of June 25, 2017, we do not have any off-balance sheet arrangements, synthetic leases, investments in special purpose entities or undisclosed borrowings or debt that would be required to be disclosed pursuant to Item 303 of

Regulation S-K under the Exchange Act.

New and Revised Financial Accounting Standards

See Note 1 to the Consolidated Financial Statements for a description of recently issued Financial Accounting Standards.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

For quantitative and qualitative disclosures about market risk, see Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” of our Annual Report on Form 10-K for the fiscal year ended December 25, 2016. Our exposures to market risk have not changed materially since December 25, 2016.

ITEM 4. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

Our management, with the participation of our interim Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of June 25, 2017. Based upon that evaluation, our interim Chief Executive Officer and Chief Financial Officer has concluded that, as of June 25, 2017, our disclosure controls and procedures were effective in ensuring that information required to be disclosed in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and is accumulated and communicated to our management, including our interim Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the fiscal quarter ended June 25, 2017 that have materially affected, or are reasonably likely to materially affect internal controls over financial reporting.

The certification required by Section 302 of the Sarbanes-Oxley Act of 2002 is filed as exhibit 31.1 to this Quarterly Report on Form 10-Q.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Information pertaining to legal proceedings is provided in Note 7 to the Condensed Consolidated Financial Statements and is incorporated by reference herein.

ITEM 1A. RISK FACTORS

A description of the risk factors associated with our business is contained in Item 1A, "Risk Factors" of our Annual Report on Form 10-K for the fiscal year ended December 25, 2016. There have been no material changes to our Risk Factors as previously reported.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

The following table contains information regarding purchases of our common stock made by or on behalf of Potbelly Corporation during the 13 weeks ended June 25, 2017:

| Period | Total Number of | | Total Number of Shares | Maximum Value of |
|---------------------------------|-----------------|--------------------|------------------------|---------------------|
| | Purchased | Average Price Paid | Purchased as Part of | Shares that May Yet |
| | Shares | per Share (1) | Publicly Announced | be Purchased Under |
| | | | Program (2) | the Program (2) |
| March 27, 2017 - April 23, 2017 | 19,000 | \$ 13.74 | 19,000 | 25,436,886 |
| April 24, 2017 - May 21, 2017 | 94,277 | \$ 11.27 | 94,277 | 24,374,734 |
| May 22, 2017 - June 25, 2017 | 147,749 | \$ 11.37 | 147,749 | 22,695,147 |
| Total: | 261,026 | | 261,026 | |

(1) Average price paid per share excludes commissions.

(2) On September 8, 2016, the Company announced that its Board of Directors approved a share repurchase program, authorizing us to repurchase up to \$30.0 million of our common stock. The Company's previous \$35.0 million share repurchase program, authorized in September 2015, was completed in July 2016. The current program permits the Company, from time to time, to purchase shares in the open market (including in pre-arranged stock trading plans in accordance with the guidelines specified in Rule 10b5-1 under the Exchange Act) or in privately negotiated transactions. No time limit has been set for the completion of the repurchase program and the program may be suspended or discontinued at any time.

ITEM 6. EXHIBITS

The following exhibits are either provided with this Quarterly Report on Form 10-Q or are incorporated herein by reference.

Exhibit

| No. | Description |
|---------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1 | Letter Agreement between Potbelly Corporation and Michael Coyne, dated July 18, 2017 (filed as Exhibit 10.1 to Form 8-K (File No. 001-36104) filed July 18, 2017 and incorporated herein by reference). † |
| 10.2 | Retention Agreement between Potbelly Corporation and Michael Coyne, dated July 17, 2017 (filed as Exhibit 10.2 to Form 8-K (File No. 001-36104) filed July 18, 2017 and incorporated herein by reference). † |
| 10.3 | Retention Agreement between Potbelly Corporation and Matthew Revord, dated July 17, 2017 (filed as Exhibit 10.3 to Form 8-K (File No. 001-36104) filed July 18, 2017 and incorporated herein by reference). † |
| 10.4 | Retention Agreement between Potbelly Corporation and Julie Younglove-Webb, dated July 17, 2017 (filed as Exhibit 10.4 to Form 8-K (File No. 001-36104) filed July 18, 2017 and incorporated herein by reference). † |
| 31.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |

Management contract or compensatory plan

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SIGNATURE

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

POTBELLY CORPORATION

Date: August 4, 2017 By: /s/ Michael Coyne
Michael Coyne
Interim Chief Executive Officer and Chief Financial Officer
(Principal Executive Officer and Principal Financial Officer)