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APPLEBEES INTERNATIONAL INC

Form 10-Q

October 29, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from to

Commission File Number: 000-17962

Applebee's International, Inc.

(Exact name of registrant as specified in its charter)

Delaware

43-1461763

(State or other jurisdiction of
incorporation or organization)

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

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

(Address of principal executive offices and zip code)

(913) 967-4000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes

☒ X

No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer ☒ X

Accelerated filer

Non-accelerated filer

Yes _____ No _____ X _____

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PART I FINANCIAL INFORMATION

Notes to Condensed Consolidated Financial Statements.....

Item 4. Controls and Procedures.....

Signatures

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

APPLEBEE'S INTERNATIONAL, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (Unaudited) (in thousands, except share amounts)

| | September 3 2007 |
|---|---------------------|
| <hr/> | |
| ASSETS | |
| Current assets: | |
| Cash and cash equivalents..... | \$ 18,912 |
| Short-term investments, at market value..... | 299 |
| Receivables, less allowance of \$677 in 2007 and \$917 in 2006..... | 39,754 |
| Inventories..... | 10,912 |
| Prepaid income taxes..... | 4,736 |
| Prepaid and other current assets..... | 19,192 |
| Assets held for sale..... | 5,273 |
| Current assets related to discontinued operations..... | 4,935 |
| | <hr/> |
| Total current assets..... | 104,013 |
| Property and equipment, net..... | 631,243 |
| Goodwill..... | 138,950 |
| Restricted assets related to captive insurance subsidiary..... | 10,755 |
| Other intangible assets, net..... | 6,028 |
| Other assets, net..... | 36,881 |
| Non-current assets related to discontinued operations..... | 2,558 |
| | <hr/> |
| | \$ 930,428 |
| | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | |
| Current liabilities: | |
| Current portion of long-term debt..... | \$ 310 |
| Accounts payable..... | 49,720 |
| Accrued expenses and other current liabilities..... | 96,348 |
| Loss reserve related to captive insurance subsidiary..... | 4,940 |
| Accrued dividends..... | -- |
| Accrued income taxes..... | -- |
| Current liabilities related to discontinued operations..... | 1,162 |
| | <hr/> |
| Total current liabilities..... | 152,480 |
| | <hr/> |
| Non-current liabilities: | |
| Long-term debt, less current portion..... | 122,697 |

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| | |
|---|------------|
| Deferred income taxes..... | 25,134 |
| Other non-current liabilities..... | 70,185 |
| Non-current liabilities related to discontinued operations..... | 6,367 |
| | ----- |
| Total non-current liabilities..... | 224,383 |
| | ----- |
| Total liabilities..... | 376,863 |
| | ----- |
| Commitments and contingencies (Note 11) | |
| Stockholders' equity: | |
| Preferred stock - par value \$0.01 per share: | |
| authorized - 1,000,000 shares; no shares issued..... | -- |
| Common stock - par value \$0.01 per share: | |
| authorized - 125,000,000 shares; issued - 108,503,243 shares..... | 1,085 |
| Additional paid-in capital..... | 274,412 |
| Retained earnings..... | 822,722 |
| | ----- |
| | 1,098,219 |
| Treasury stock - 33,343,536 shares in 2007 and 34,393,331 shares | |
| in 2006, at cost..... | (544,654) |
| | ----- |
| Total stockholders' equity..... | 553,565 |
| | ----- |
| | \$ 930,428 |
| | ===== |

See notes to condensed consolidated financial statements.

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

| | 13 Weeks Ended | |
|---|-----------------------|-----------------------|
| | September 30, 2007 | September 24, 2006 |
| | ----- | ----- |
| Operating revenues: | | |
| Company restaurant sales..... | \$ 288,861 | \$ 280,480 |
| Franchise royalties and fees..... | 34,357 | 33,340 |
| Other franchise income..... | 475 | 371 |
| | ----- | ----- |
| Total operating revenues..... | 323,693 | 314,191 |
| | ----- | ----- |
| Cost of company restaurant sales: | | |
| Food and beverage..... | 77,093 | 74,856 |
| Labor..... | 101,951 | 96,353 |
| Direct and occupancy..... | 83,262 | 77,296 |
| Pre-opening expense..... | 214 | 1,115 |
| | ----- | ----- |
| Total cost of company restaurant sales..... | 262,520 | 249,620 |
| | ----- | ----- |
| Cost of other franchise income..... | 357 | 694 |

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| | | |
|--|-----------|-----------|
| General and administrative expenses..... | 35,566 | 35,601 |
| Amortization of intangible assets..... | 128 | 154 |
| Impairment and other restaurant closure costs..... | 74 | 1,296 |
| Loss on disposition of property and equipment..... | 655 | 680 |
| | ----- | ----- |
| Operating earnings..... | 24,393 | 26,146 |
| | ----- | ----- |
| Other income (expense): | | |
| Investment income..... | 746 | 885 |
| Interest expense..... | (1,945) | (2,970) |
| Other income (expense)..... | (66) | 301 |
| | ----- | ----- |
| Total other expense..... | (1,265) | (1,784) |
| | ----- | ----- |
| Earnings from continuing operations before income | | |
| taxes..... | 23,128 | 24,362 |
| Income taxes..... | 7,322 | 8,849 |
| | ----- | ----- |
| Earnings from continuing operations..... | 15,806 | 15,513 |
| Loss from discontinued operations, net of tax..... | (42) | (672) |
| | ----- | ----- |
| Net earnings..... | \$ 15,764 | \$ 14,841 |
| | ===== | ===== |
| Basic net earnings per common share: | | |
| Earnings from continuing operations..... | \$ 0.21 | \$ 0.21 |
| Loss from discontinued operations, net of tax..... | -- | (0.01) |
| | ----- | ----- |
| Basic net earnings per common share..... | \$ 0.21 | \$ 0.20 |
| | ===== | ===== |
| Diluted net earnings per common share: | | |
| Earnings from continuing operations..... | \$ 0.21 | \$ 0.21 |
| Loss from discontinued operations, net of tax..... | -- | (0.01) |
| | ----- | ----- |
| Diluted net earnings per common share..... | \$ 0.21 | \$ 0.20 |
| | ===== | ===== |
| Basic weighted average shares outstanding..... | 74,178 | 73,902 |
| | ===== | ===== |
| Diluted weighted average shares outstanding..... | 75,287 | 74,673 |
| | ===== | ===== |

See notes to condensed consolidated financial statements.

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

| | | |
|--------------|------------|--------|
| Common Stock | Additional | Retain |
| ----- | Paid-In | |

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| | Shares | Amount | Capital | Earnings |
|---|---------|----------|------------|------------|
| | ----- | ----- | ----- | ----- |
| Balance, December 31, 2006 | 108,503 | \$ 1,085 | \$ 265,122 | \$ 774,000 |
| Net earnings..... | -- | -- | -- | 49,000 |
| Purchases of treasury stock..... | -- | -- | -- | |
| Stock options exercised and related tax benefit..... | -- | -- | 2,330 | |
| Shares issued under employee benefit plans..... | -- | -- | 1,474 | |
| Nonvested shares awarded under equity incentive plans..... | -- | -- | (6,799) | |
| Stock-based compensation expense related to employee-based equity awards..... | -- | -- | 12,285 | |
| Cumulative impact of change in accounting for uncertainty in income taxes (Note 9)..... | -- | -- | -- | (1,000) |
| | ----- | ----- | ----- | ----- |
| Balance, September 30, 2007..... | 108,503 | \$ 1,085 | \$ 274,412 | \$ 822,000 |
| | ===== | ===== | ===== | ===== |

See notes to condensed consolidated financial statements.

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

| | 39 Weeks Ended |
|---|-----------------------|
| | ----- |
| | September 30, 2007 |
| | ----- |
| CASH FLOWS FROM OPERATING ACTIVITIES: | |
| Net earnings..... | \$ 49,388 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | |
| Depreciation and amortization..... | 51,225 |
| Amortization of intangible assets..... | 382 |
| Stock-based compensation..... | 12,285 |
| Other amortization..... | 250 |
| Deferred income tax benefit..... | (5,815) |
| Impairment and other restaurant closure costs..... | 25,935 |
| Loss on disposition of property and equipment..... | 686 |
| Income tax benefit from stock-based compensation..... | 456 |
| Changes in assets and liabilities, exclusive of effect of acquisition: | |
| Receivables..... | 8,470 |
| Inventories..... | 522 |
| Prepaid and other current assets..... | (661) |
| Accounts payable..... | 3,478 |

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| | |
|--|-----------|
| Accrued expenses and other current liabilities..... | (17,824) |
| Loss reserve and unearned premiums related to captive insurance subsidiary..... | (1,154) |
| Income taxes..... | (13,946) |
| Other non-current liabilities..... | 6,481 |
| Other..... | (3,684) |
| NET CASH PROVIDED BY OPERATING ACTIVITIES..... | 116,474 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | |
| Purchases of property and equipment..... | (65,276) |
| Change in restricted assets related to captive insurance subsidiary..... | 2,601 |
| Acquisition of restaurants..... | -- |
| Proceeds from sale of property and equipment..... | 4,949 |
| NET CASH USED BY INVESTING ACTIVITIES..... | (57,726) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | |
| Purchases of treasury stock..... | (999) |
| Dividends paid..... | (16,299) |
| Issuance of common stock upon exercise of stock options..... | 4,001 |
| Shares issued under employee benefit plans..... | 2,831 |
| Excess tax benefits from stock-based compensation..... | 499 |
| Net debt proceeds (payments)..... | (52,178) |
| NET CASH USED BY FINANCING ACTIVITIES..... | (62,145) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS..... | (3,397) |
| CASH AND CASH EQUIVALENTS, beginning of period..... | 22,309 |
| CASH AND CASH EQUIVALENTS, end of period..... | \$ 18,912 |

See notes to condensed consolidated financial statements.

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

SUPPLEMENTAL DISCLOSURES OF CASH

FLOW INFORMATION:

Cash paid during the 39 week period for:

| | |
|-------------------|-----------|
| Income taxes..... | \$ 32,256 |
| Interest..... | \$ 7,862 |

SUPPLEMENTAL DISCLOSURES OF NON-CASH INVESTING AND FINANCING ACTIVITIES:

We issued nonvested shares with grant date fair values of \$18,314,000 for the 39 weeks ended September 30, 2007 and nonvested shares of \$3,598,000 for the 39 weeks ended September 24, 2006.

We have entered into a rabbi trust agreement to protect the assets of the nonqualified deferred compensation plan for certain of our associates. The plan investments are included in other assets and the offsetting obligation is included in other non-current liabilities in our consolidated balance sheets. We had a non-cash increase in this balance of \$781,000 for the 39 weeks ended September 30, 2007 and a non-cash increase of \$1,522,000 for the 39 weeks ended September 24, 2006.

We had property and equipment purchases accrued in accounts payable of approximately \$13,500,000 as of September 30, 2007 and September 24, 2006.

See notes to condensed consolidated financial statements.

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

1. Basis of Presentation

Our condensed consolidated financial statements included in this Form 10-Q have been prepared without audit in accordance with the rules and regulations of the Securities and Exchange Commission ("SEC"). Although certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted, we believe that the disclosures are adequate to make the information presented not misleading. The accompanying condensed consolidated financial statements should be read in conjunction with the audited financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

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

References to "Applebee's," "we," "us," and "our" in this document are references to Applebee's International, Inc. and its subsidiaries and any predecessor companies of Applebee's International, Inc.

References to the 13 weeks ended September 30, 2007 and September 24, 2006 will be referred to as the "2007 quarter" and the "2006 quarter", respectively. References to the 39 weeks ended September 30, 2007 and September 24, 2006 will be referred to as the "2007 year-to-date period" and the "2006 year-to-date period", respectively.

As discussed in Note 5, we have presented the closure of 19 restaurants as

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discontinued operations in our condensed consolidated financial statements and have made certain conforming changes to prior periods.

2. Stock-Based Compensation

In 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment." SFAS 123(R) requires all stock-based compensation, including grants of employee stock options, to be recognized in the statement of earnings based on fair value. With limited exceptions, the amount of compensation cost is measured based on the fair value on the grant date of the equity or liability instruments issued.

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Stock-based compensation expense was \$4,604,000 and \$5,172,000 for the 2007 quarter and the 2006 quarter, respectively, and \$12,285,000 and \$16,584,000 for the 2007 year-to-date period and the 2006 year-to-date period, respectively. We granted the following awards which vest on March 1, 2011:

| | 2007 Quarter | 2007 Year-to-Date Period |
|---|-----------------|--------------------------------|
| | ----- | ----- |
| Stock Options..... | -- | 79,000 |
| Stock Appreciation Rights ("SARs")..... | 113,000 | 325,000 |
| Nonvested Shares(1)..... | 216,000 | 728,000 |
| Restricted Stock Units..... | 3,000 | 10,000 |

3. Net Earnings Per Share

We compute basic net earnings per common share by dividing income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted net earnings per common share reflects the potential dilution that could occur if holders of options or other contracts to issue common stock exercised or converted their holdings into common stock. Outstanding stock options, SARs and other equity-based compensation represent the only dilutive effects on weighted average shares. The table below presents a reconciliation between basic and diluted weighted average shares outstanding and the related net earnings per share. All amounts in the table, except per share amounts, are expressed in thousands.

| | 2007 Quarter | 2006 Quarter | 2007 Year-to-Date Period |
|--|-----------------|-----------------|--------------------------------|
| | ----- | ----- | ----- |
| Earnings from continuing operations..... | \$ 15,806 | \$ 15,513 | \$ 63,072 |
| Loss from discontinued operations, net of tax..... | (42) | (672) | (13,684) |
| | ----- | ----- | ----- |
| Net earnings..... | \$ 15,764 | \$ 14,841 | \$ 49,388 |
| | ===== | ===== | ===== |

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| | | | |
|---|---------|---------|---------|
| Basic weighted average shares outstanding..... | 74,178 | 73,902 | 74,078 |
| Dilutive effect of stock options, SARs and other equity-based compensation..... | 1,109 | 771 | 1,108 |
| | ----- | ----- | ----- |
| Diluted weighted average shares outstanding..... | 75,287 | 74,673 | 75,186 |
| | ===== | ===== | ===== |
| Basic net earnings per common share: | | | |
| Earnings from continuing operations..... | \$ 0.21 | \$ 0.21 | \$ 0.85 |
| Loss from discontinued operations, net of tax.... | -- | (0.01) | (0.18) |
| | ----- | ----- | ----- |
| Basic net earnings per common share..... | \$ 0.21 | \$ 0.20 | \$ 0.67 |
| | ===== | ===== | ===== |
| Diluted net earnings per common share: | | | |
| Earnings from continuing operations..... | \$ 0.21 | \$ 0.21 | \$ 0.84 |
| Loss from discontinued operations, net of tax... | -- | (0.01) | (0.18) |
| | ----- | ----- | ----- |
| Diluted net earnings per common shares..... | \$ 0.21 | \$ 0.20 | \$ 0.66 |
| | ===== | ===== | ===== |

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We excluded stock options and SARs with exercise prices greater than the average market price of our common stock for the applicable periods from the computation of diluted weighted average shares outstanding as the effect would be anti-dilutive. We excluded approximately 4,100,000 and 2,600,000 of these options and SARs from our diluted weighted average share computation for the 2007 quarter and the 2006 quarter, respectively, and approximately 4,000,000 and 3,100,000 of these options and SARs for the 2007 year-to-date period and 2006 year-to-date period, respectively.

4. Acquisition

The acquisition discussed below has been accounted for using the purchase method of accounting and, accordingly, our condensed consolidated financial statements reflect the results of operations for the acquisition subsequent to the date of acquisition. The assets acquired and liabilities assumed are recorded at estimates of fair value as determined by management based upon information available.

In January 2006, we completed the acquisition of four Applebee's restaurants in the Houston market for approximately \$8,100,000 in cash. The purchase price was allocated to the fair value of property and equipment of \$7,400,000, goodwill of approximately \$500,000, reacquired franchise rights of approximately \$100,000, and other net assets of approximately \$100,000. The proforma impact on our results of operations was immaterial.

We finalize the allocation of purchase price to the fair value of assets acquired and liabilities assumed when we obtain information sufficient to complete the allocation, but in each case, no longer than one year after the acquisition date.

5. Restaurant Closures and Impairments

In March 2007, we announced that the Board of Directors had approved management's recommendation to close 24 underperforming restaurants located in 11 states which we determined did not have the potential to deliver acceptable long-term returns on invested capital. We closed 19 restaurants in the first

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fiscal quarter of 2007 and four restaurants in the second quarter of fiscal 2007, leaving one of the 24 underperforming restaurants still open.

We believe that four of the closed restaurants will have significant sales transfer to other existing restaurant locations and, therefore, are not presented as discontinued operations in our condensed consolidated financial statements as required by SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." The results of operations, impairment charges and lease obligations related to these four restaurants have been presented within operating earnings in the condensed consolidated statement of earnings.

In the 2007 quarter and 2007 year-to-date period, we have presented the results of operations for 19 of the closed restaurants as discontinued operations in our condensed consolidated financial statements as required by SFAS No. 144. In addition, we have presented the impairment charge and lease obligations for these restaurants in discontinued operations. Company restaurant sales for the restaurants presented in discontinued operations were \$6,458,000 in the 2006 quarter and \$7,298,000 and \$20,593,000 in the 2007 year-to-date period and 2006 year-to-date period, respectively.

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The charges in the 2007 quarter and the 2007 year-to-date period included the following (in thousands):

| | 2007 Quarter | |
|---|---|-----------------------|
| | Impairment and Other Restaurant Closure Costs | Discontin Operatio |
| Write-down of the carrying value of property and equipment and other assets..... | \$ 6 | \$ 30 |
| Lease obligation for closed restaurants..... | 68 | 192 |
| Income from operations for discontinued operations..... | -- | (39) |
| Loss on sale of property and equipment..... | -- | 116 |
| Income tax benefit for discontinued operations..... | -- | (257) |
| Total costs..... | \$ 74 | \$ 42 |
| | ===== | ===== |
| | 2007 Year-to-Date Period | |
| | Impairment and Other Restaurant Closure Costs | Discontin Operatio |
| Write-down of the carrying value of property and equipment and other assets..... | \$ 3,249 | \$ 11,945 |
| Lease obligation for closed restaurants..... | 2,579 | 9,243 |
| Other costs..... | 2 | 311 |
| Loss from operations for discontinued operations..... | -- | 575 |
| Gain on sale of property and equipment..... | -- | (592) |
| Income tax benefit for discontinued operations..... | -- | (7,798) |
| | ----- | ----- |

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| | | |
|------------------|----------|-----------|
| Total costs..... | \$ 5,830 | \$ 13,684 |
| | ===== | ===== |

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The current and non-current assets and liabilities of the 19 restaurants that are presented as discontinued operations in the condensed consolidated balance sheet are as follows (in thousands):

| | September 30, 2007 | De |
|---|-----------------------|-------|
| | ----- | ----- |
| Current assets: | | |
| Property and equipment, net(1)..... | \$ 4,043 | \$ |
| Other assets, net(1)..... | 562 | |
| Prepaid income taxes..... | 330 | |
| | ----- | ----- |
| Current assets related to discontinued operations..... | \$ 4,935 | \$ |
| | ===== | ===== |
| Non-current assets: | | |
| Deferred income taxes..... | \$ 2,558 | \$ |
| Property and equipment, net..... | -- | |
| Other assets, net..... | -- | |
| | ----- | ----- |
| Non-current assets related to discontinued operations..... | \$ 2,558 | \$ |
| | ===== | ===== |
| Current liabilities: | | |
| Accrued expenses and other current liabilities..... | \$ 1,162 | \$ |
| | ----- | ----- |
| Current liabilities related to discontinued operations..... | \$ 1,162 | \$ |
| | ===== | ===== |
| Non-current liabilities: | | |
| Other non-current liabilities..... | \$ 6,367 | \$ |
| | ----- | ----- |
| Non-current liabilities related to discontinued operations..... | \$ 6,367 | \$ |
| | ===== | ===== |

We had the following activity in our liabilities related to all of the closed restaurants:

| | 2007 Quarter | | 2007 Year-to- |
|--------------------------------------|----------------------|----------------|----------------------|
| | ----- | ----- | ----- |
| | Lease Obligations | Other Costs | Lease Obligations |
| | ----- | ----- | ----- |
| Balance, at beginning of period..... | \$ 10,627 | \$ 173 | \$ 956 |
| Additions..... | 240 | -- | 11,718 |
| Payments..... | (432) | -- | (2,239) |

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| | | | |
|----------------------------------|-----------|--------|-----------|
| Balance, September 30, 2007..... | \$ 10,435 | \$ 173 | \$ 10,435 |
| | ===== | ===== | ===== |

In the 2006 quarter, we recorded impairment and other restaurant closure costs of \$1,900,000, which consisted of an asset impairment charge of approximately \$1,000,000 related to the write-down of the carrying value of two restaurants whose carrying amounts were deemed not recoverable and approximately \$900,000 write-down of a corporate aircraft. We have presented approximately \$600,000 of the impairment and other restaurant closure costs related to the 19 closed restaurants as discontinued operations in our condensed consolidated financial statements.

In the 2006 year-to-date period, we recorded impairment and other restaurant closure costs of \$6,500,000 which includes approximately \$700,000 related to lease obligations, approximately \$4,700,000 related to the write-down of the

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carrying value of property and equipment and \$1,100,000 related to the write-off of lease acquisition costs. We have presented approximately \$4,100,000 of the impairment and other restaurant closure costs related to the 19 closed restaurants as discontinued operations in our condensed consolidated financial statements.

In assessing restaurants for impairment, we use current and historical operating results to estimate future cash flows on a restaurant by restaurant basis. Generally, the asset impairment charges for all periods presented were calculated by comparing the carrying value of the restaurants' assets to the estimated future cash flow projections. In addition, we calculated the impairment charges for the assets which we classified as held for sale in the first quarter of 2007 based upon the expected proceeds, net of any commission.

6. Assets Held for Sale

We classify assets as held for sale and cease amortizing the assets when there is a plan for disposal of assets and those assets meet the held for sale criteria as defined in SFAS No. 144. During 2006, we began to actively market our existing corporate headquarters and one of our two corporate aircraft under a plan approved by our Board of Directors, as well as other assets with immaterial carrying values. Consequently, these assets were classified as held for sale as of December 31, 2006. In 2007, we began to actively market the assets of four owned properties which were closed in the first fiscal quarter of 2007 as well as other miscellaneous items.

In February 2007, the corporate aircraft was sold for approximately \$2,500,000 and we recognized an immaterial gain. In May 2007, we signed a contract to sell the current corporate headquarters for \$9,200,000, net of commissions. We anticipate closing this transaction early in fiscal 2008.

In the second quarter of fiscal 2007, we sold assets related to two restaurants closed in the first quarter of fiscal 2007 which have been presented as discontinued operations. The gain of approximately \$700,000 has been included in our consolidated statement of earnings as discontinued operations in both periods.

7. Goodwill and Other Intangible Assets

Changes in goodwill are summarized below (in thousands):

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| | September 30, 2007 | De |
|---|-----------------------|----|
| Carrying amount, beginning of the year..... | \$ 138,950 | \$ |
| Goodwill acquired during the period..... | -- | |
| Carrying amount, end of the period..... | \$ 138,950 | \$ |

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

| | September 30, 2007 | | |
|------------------------------------|--------------------------|-----------------------------|-----------|
| | Gross Carrying Amount | Accumulated Amortization | Net Va |
| Amortized intangible assets: | | | |
| Franchise interest and rights..... | \$ 6,371 | \$ 6,303 | \$ |
| Lease acquisition costs..... | 3,430 | 834 | |
| Noncompete agreement..... | 350 | 264 | |
| Total..... | \$ 10,151 | \$ 7,401 | \$ |
| | ===== | ===== | ===== |
| | December 31, 2006 | | |
| | Gross Carrying Amount | Accumulated Amortization | Net Va |
| Amortized intangible assets: | | | |
| Franchise interest and rights..... | \$ 6,371 | \$ 6,172 | \$ |
| Lease acquisition costs..... | 3,430 | 650 | |
| Noncompete agreement..... | 350 | 199 | |
| Total..... | \$ 10,151 | \$ 7,021 | \$ |
| | ===== | ===== | ===== |

We expect annual amortization expense for amortizable other assets for the next five fiscal years to range from approximately \$200,000 to \$500,000.

Intangible assets not subject to amortization are summarized below (in thousands):

September 30,
2007

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| | | |
|--|----------|----|
| Carrying amount, beginning of the year..... | \$ 3,278 | \$ |
| Nonamortizable intangible assets acquired during the period..... | -- | |
| Nonamortizable intangible assets amount, end of the period(1)..... | \$ 3,278 | \$ |

In connection with our acquisition of four Applebee's restaurants in Houston from a franchisee in January 2006, we recorded approximately \$100,000 of reacquired franchise rights (Note 4).

The amount allocated to reacquired franchise rights is based upon the initial franchise fees received from these franchisees. This intangible asset has an indefinite life and, accordingly, will not be amortized but tested for impairment at least annually.

8. Captive Insurance Subsidiary

In 2002, we formed Neighborhood Insurance, Inc., a Vermont corporation and a wholly-owned captive insurance subsidiary to provide Applebee's International, Inc. and qualified franchisees with workers' compensation and general liability insurance. Through 2005, Applebee's International, Inc. and covered franchisees made premium payments to the captive insurance company which pays administrative

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fees and insurance claims, subject to individual and aggregate maximum claim limits under the captive insurance company's reinsurance policies. Franchisee premium amounts billed by the captive insurance company were established based upon third-party actuarial estimates of settlement costs for incurred and anticipated claims and administrative fees. In 2006, we discontinued writing insurance coverage for new or existing participants. Cost of other franchise income includes costs related to the resolution of claims arising from franchisee participation in our captive insurance program. We do not expect franchisee participation in the captive insurance company to have a material impact on our net earnings. Our consolidated balance sheets include the following balances related to the captive insurance subsidiary:

- o Franchise premium receivables of approximately \$200,000 and \$400,000 as of September 30, 2007 and December 31, 2006, respectively, included in receivables.
- o Cash equivalent and other long-term investments restricted for the payment of claims of approximately \$10,000,000 and \$12,600,000 as of September 30, 2007 and December 31, 2006, respectively, included in restricted assets related to captive insurance subsidiary.
- o Loss reserve related to captive insurance subsidiary of approximately \$8,100,000 and \$12,600,000 as of September 30, 2007 and December 31, 2006, respectively. Approximately \$3,200,000 and \$6,500,000 for September 30, 2007 and December 31, 2006, respectively, is included in other non-current liabilities.

9. Accounting for Uncertainty in Income Taxes

On January 1, 2007, we adopted the provisions of Financial Accounting Standards Board ("FASB") Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes." As a result of the implementation of FIN No. 48, we recognized an

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increase of \$1,550,000 in the liability for unrecognized tax benefits, which was accounted for as a reduction to our retained earnings balance as of the adoption date.

We file income tax returns which are periodically audited by various federal, state and foreign jurisdictions. With few exceptions, we are no longer subject to federal, state and foreign tax examinations for years prior to 2003.

As of September 30, 2007, we have approximately \$7,800,000 of unrecognized tax benefits, including approximately \$2,500,000 of interest and penalties, which are included in accrued income taxes in the consolidated balance sheet. During the 2007 quarter and the 2007 year-to-date period ended September 30, 2007, we recognized approximately \$300,000 and \$900,000 in potential interest and penalties associated with uncertain tax positions. The entire balance of unrecognized tax benefits, if recognized, would affect the effective tax rate.

We do not anticipate that total unrecognized tax benefits will significantly change due to the settlement of audits and the expiration of statutes of limitations within 12 months of the report date.

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10. Treasury Shares

As of September 30, 2007, we had approximately 33,344,000 shares held in treasury. A reconciliation of our treasury shares for the 2007 year-to-date period is provided below (shares in thousands):

| | Treasury Shares |
|---|--------------------|
| | ----- |
| Balance as of December 31, 2006..... | 34,393 |
| Purchases of treasury stock..... | 42 |
| Stock options exercised..... | (251) |
| Shares issued under employee benefit plans..... | (134) |
| Nonvested shares awarded under equity incentive plans..... | (706) |
| | ----- |
| Balance as of September 30, 2007..... | 33,344 |
| | ===== |

11. Commitments and Contingencies

Litigation, claims and disputes: We are subject from time to time to lawsuits, claims and governmental inspections or audits arising in the ordinary course of business. Some of these lawsuits purport to be class actions and/or seek substantial damages. In the opinion of management, these matters are adequately covered by insurance, or, if not so covered, are without merit or are of such a nature or involve amounts that would not have a material adverse impact on our business or consolidated financial position.

On July 26, 2007, the New Jersey Building Laborers Pension and Annuity Funds filed a putative class action complaint in the Court of Chancery of the State of Delaware for New Castle County against Applebee's International, Inc., its directors, and IHOP Corporation. On September 14, 2007, the plaintiff in this matter filed an amended complaint against the same defendants. The amended

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complaint alleges, among other things, that the proposed transaction with IHOP is unfair to Applebee's stockholders. As relief, the amended complaint seeks to enjoin the transaction and seeks monetary damages in an unspecified amount. The parties have agreed in principle to a disclosure-based settlement described in a Memorandum of Understanding which was submitted to the Court on October 12, 2007. The proposed settlement is subject to, among other things, confirmatory discovery by plaintiffs, notice to the putative class members and approval by the Court.

We are currently defending a collective action filed under the Fair Labor Standards Act styled Gerald Fast v. Applebee's International, Inc., in which named plaintiffs claim that tipped workers in company restaurants perform excessive amounts of non-tipped work for which they should be compensated at the minimum wage. The court has conditionally certified a nationwide class of servers and bartenders who have worked in company-owned restaurants since June 19, 2004. Unlike a class action, a collective action requires potential class members to "opt in" rather than "opt out." Therefore, the number of class members will not be known until the end of 2007, when the opt in period expires. Conditional certification is granted under a lenient standard and the company will have an opportunity to have the class de-certified following the close of discovery at the end of 2008. The company believes it has strong defenses supporting the de-certification of the class, as well as strong defenses to the substantive claims asserted, and intends to vigorously defend this case. An

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estimate of the possible loss, if any, or the range of the loss cannot be made and therefore, the Company has not accrued a loss contingency related to this matter.

Lease guarantees and contingencies: In connection with the sale of restaurants to franchisees and other parties, we have, in certain cases, remained contingently liable for the remaining lease payments. As of September 30, 2007, we have outstanding lease guarantees of approximately \$13,900,000. In addition, we or our subsidiaries are contingently liable for various leases that we have assigned in connection with the sale of restaurants to franchisees and other parties in the potential amount of \$11,100,000. These leases expire at various times with the final lease agreement expiring in 2018. The sale of virtually all of the restaurants involving these lease contingencies occurred prior to the effective date of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45") and, therefore, we were not required to record a liability for these guarantees following the prospective application guidance. The fair value of the few remaining lease guarantees entered into after the date of adoption are immaterial to our condensed consolidated financial statements, thus we did not record a liability related to these contingent lease liabilities as of September 30, 2007 or December 31, 2006.

Franchisee guarantees: In 2004, we arranged for a third-party financing company to provide up to \$250,000,000 to qualified franchisees for loans to fund development of new restaurants through October 2007, subject to our approval. We will provide a limited guarantee of 10% of certain loans advanced under this program. We will be released from our guarantee if certain operating results are met after the restaurant has been open for at least two years. As of September 30, 2007, there were loans outstanding to five franchisees for approximately \$34,900,000, net of any guarantees in which we were released, under this program. The fair value of our guarantees under this financing program is approximately \$100,000 and is recorded in non-current liabilities in our consolidated balance sheet as of September 30, 2007. This program will expire on October 31, 2007.

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Severance agreements: We have severance and employment agreements with certain officers providing for severance payments to be made in the event the officer resigns or is terminated not related to a change in control, some of which require payments to be made only if we enforce certain terms in the agreements. If the severance payments had been due as of September 30, 2007, we would have been required to make payments totaling approximately \$10,400,000. In addition, we have severance and employment agreements with certain officers which contain severance provisions related to a change in control. The agreements define the circumstances which will constitute a change in control. Those provisions would have required additional aggregate payments of approximately \$6,400,000 if such officers had been terminated as of September 30, 2007.

12. Corporate Headquarters Incentives

During the second quarter of fiscal 2007, we entered into a transaction with the City of Lenexa, Kansas ("City"), to lease the land, building and property and equipment for our new corporate headquarters ("the facility"). The transaction is designed to provide us with property tax exemptions for the facility of up to 90% after the effect of payments in lieu of taxes paid to the City.

In conjunction with the lease, the City will purchase the facility with the proceeds of up to \$52 million in Industrial Revenue Bonds ("IRBs") due May 1, 2018 which will be funded periodically during the construction period. Applebee's International, Inc. is the sole purchaser of the IRBs. The City has assigned the lease to the bond trustee for the benefit of the bondholder. As the sole bondholder, in effect, we control the enforcement of the lease against ourselves. During the 2007 year-to-date period, we have funded approximately

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\$4,500,000 of the IRBs and have included this amount in property and equipment in our consolidated balance sheet. Due to the bargain purchase option contained within the lease, we have classified this amount as a capital lease. As a result of the right to offset, the capital lease obligation and the corresponding bond investments have been offset in the condensed consolidated balance sheet.

13. New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The impact of this adoption will not be material to our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." This statement requires companies to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. The statement requires prospective application, and the recognition and disclosure requirements are effective for companies with fiscal years ending after December 15, 2006. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. The impact of this adoption was not material to our consolidated financial statements and we are in compliance with the measurement date provisions of this statement.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities." This statement permits entities to choose to

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measure many financial instruments and certain other items at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating the impact of this adoption on our consolidated financial statements.

14. IHOP Proposed Merger

On July 15, 2007, we entered into a definitive agreement under which IHOP Corp. ("IHOP") will acquire the outstanding stock of the Company for \$25.50 per share in cash, representing a total transaction value of approximately \$2.1 billion. IHOP plans to fund the majority of the acquisition price through a whole-business securitization of the Applebee's business or will use bridge financing previously committed. The all-cash transaction, which is expected to close by November 29, 2007, is subject to the approval of Applebee's shareholders and customary closing conditions. Applebee's shareholders will vote on October 30, 2007, whether to accept the proposed merger. This transaction represents the culmination of a comprehensive strategic alternatives process announced in February 2007, which was led by the Strategy Committee of our Board of Directors.

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

Introductory Note

On July 15, 2007, we entered into a definitive agreement under which IHOP Corp. ("IHOP") will acquire the outstanding stock of the Company for \$25.50 per share in cash, representing a total transaction value of approximately \$2.1 billion. IHOP plans to fund the majority of the acquisition price through a whole-business securitization of the Applebee's business or will use bridge financing previously committed. The all-cash transaction, which is expected to close by November 29, 2007, is subject to the approval of Applebee's shareholders and customary closing conditions. Applebee's shareholders will vote on October 30, 2007, whether to accept the proposed merger. This transaction represents the culmination of a comprehensive strategic alternatives process announced in February 2007, which was led by the Strategy Committee of our Board of Directors.

Forward-Looking Statements

The statements contained in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section regarding restaurant development, comparable sales, revenue growth, restaurant margins, commodity costs, general and administrative expenses, capital expenditures, return on invested capital and financial commitments are forward-looking and based on current expectations. There are several risks and uncertainties that could cause actual results to differ materially from those described. These risks include, but are not limited to, our pending merger with IHOP, our ability and the ability of our franchisees to open and operate additional restaurants profitably and generate positive operating cash flows and return on invested capital, the impact of economic and demographic factors on consumer spending, maintaining and growing the value of the Applebee's brand, the impact of intense competition in the casual dining segment of the restaurant industry, the impact of future leverage on our operations, the failure to open the restaurants anticipated, the impact of increases in capital expenditure costs on future development, our ability to attract and retain qualified franchisees, and the impact of further

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penetration of restaurants in existing markets. For a more detailed discussion of the principal factors that could cause actual results to be materially different, you should read our risk factors in Item 1A of our 2006 Annual Report on Form 10-K. We disclaim any obligation to update forward-looking statements.

Additional Information and Where to Find It

In connection with the proposed transaction, IHOP Corp. and Applebee's International will be filing documents with the Securities and Exchange Commission (the "SEC"), and Applebee's has filed a related definitive proxy statement. Investors and security holders are urged to read the definitive proxy statement because it contains important information about the proposed transaction. Investors and security holders may obtain free copies of the definitive proxy statement and other documents filed with the SEC at the SEC's website at www.sec.gov. In addition, investors and security holders may obtain free copies of the documents filed with the SEC by IHOP Corp. by contacting IHOP Investor Relations at 818-240-6055. Investors and security holders may obtain free copies of the documents filed with the SEC by Applebee's by contacting Applebee's Investor Relations at 913-967-4000. In addition, you may also find information about the merger transaction at www.ihopapplebeesacquisition.com.

Applebee's and their directors and executive officers may be deemed participants in the solicitation of proxies from the stockholders of Applebee's in connection with the proposed transaction. Information regarding the special interests of

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these directors and executive officers in the proposed transaction is included in the definitive proxy statement of Applebee's described above. Additional information regarding the directors and executive officers of Applebee's is also included in Applebee's proxy statement for its 2007 Annual Meeting of Stockholders, which was filed with the SEC on April 9, 2007, and the supplemental proxy statement filed on May 1, 2007. These documents are available free of charge at the SEC's website at www.sec.gov and from Investor Relations at IHOP and Applebee's as described above.

General

We operate on a 52 or 53 week fiscal year ending on the last Sunday in December. Our fiscal years and fiscal periods are as follows:

| Fiscal Year | Fiscal Year End | Number of Weeks |
|--------------------------|--------------------|--------------------|
| ----- | ----- | ----- |
| 2006 | December 31, 2006 | 53 |
| 2007 | December 30, 2007 | 52 |
| 2008 | December 28, 2008 | 52 |
| Fiscal Period | Fiscal Period End | Number of Weeks |
| ----- | ----- | ----- |
| 2006 Quarter | September 24, 2006 | 13 |
| 2007 Quarter | September 30, 2007 | 13 |
| 2006 Year-to-date period | September 24, 2006 | 39 |
| 2007 Year-to-date period | September 30, 2007 | 39 |

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Our operating revenues are generated from three sources:

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

Beverage sales consist of sales of alcoholic beverages, while non-alcoholic beverages are included in food sales.

Franchise royalties are generally 4% of each franchise restaurant's monthly gross sales. Franchise fees typically are \$35,000 for each restaurant opened.

Other franchise income includes revenue from information technology products and services provided to certain franchisees.

Certain expenses relate only to company-owned restaurants. These include:

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

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Cost of other franchise income includes costs related to information technology products and services provided to certain franchisees and costs related to the resolution of claims arising from franchisee participation in our captive insurance program.

Other expenses relate to both company-owned restaurants and franchise operations.

All references to company comparable sales, average weekly sales and guest traffic in all periods contained herein include the restaurants presented in discontinued operations unless noted otherwise.

Overview

Applebee's International, Inc. and our subsidiaries develop, franchise and operate casual dining restaurants under the name "Applebee's Neighborhood Grill & Bar(R)," which is the largest casual dining concept in the world with over 1,900 system-wide restaurants open as of September 30, 2007(1). The casual dining segment of the restaurant industry is highly competitive and there are many factors that affect our profitability. Our industry is susceptible to changes in economic conditions, trends in lifestyles, fluctuating costs, government regulation, availability of resources and consumer perceptions. When evaluating and assessing our financial performance, we believe there are five key factors:

- o Development - the number of new company and franchise restaurants opened during the period. Our expansion strategy has been to cluster restaurants in targeted markets, thereby increasing consumer awareness and convenience, and enabling us to take advantage of operational, distribution and advertising efficiencies. We currently expect that the Applebee's system will ultimately encompass at least 3,000 restaurants in the United States, as well as the potential for at least 1,000 restaurants internationally. We and our franchisees opened 2 and 14 restaurants in the 2007 quarter, respectively, and opened 12 and 42 restaurants in the 2007 year-to-date period, respectively. During the 2007 quarter, we opened a company-owned restaurant in Shanghai, China.

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- o Comparable restaurant sales - a year-over-year comparison of sales for restaurants open at least 18 months. Changes in comparable restaurant sales are driven by changes in the average guest check and/or changes in guest traffic. Average guest check changes result from menu price changes and/or changes in menu mix. The impact of menu price increases on company restaurant sales was approximately 2.7% during both the 2007 quarter and 2007 year-to-date period. Although we may have changes in our average guest check from period to period, our main focus has been increasing guest traffic as we view this component to be more indicative of the long-term health of the Applebee's brand. We are constantly seeking to increase guest traffic by focusing on improving operations and enhancing our menu with new food and beverage offerings including the implementation of programs such as our new lunch menu initiated in February 2007. In the 2007 quarter, company comparable sales decreased 0.2%, while domestic franchise and domestic system-wide comparable sales decreased 0.4% and 0.3%, respectively. In the 2007 year-to-date period, company comparable sales decreased 2.0%, while domestic franchise and domestic system-wide comparable sales decreased 1.7% and 1.8%, respectively. We believe our sales and traffic have been negatively impacted by multiple factors. Lower income households, which represent a significant portion of our guests, have been impacted by higher energy costs and interest rates. The bar and grill category of the restaurant industry has been negatively impacted by dining at home as well as increased trade-down

(1) Source: Nation's Restaurant News, "Special Report: Top 100," June 25, 2007.

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to quick-service restaurants. In addition, the supply growth of units opened in the category over the last three years has outpaced demand contributing to weaker sales trends.

- o Company restaurant margins - company restaurant sales, less food and beverage, labor, direct and occupancy restaurant costs and pre-opening expenses, expressed as a percentage of company restaurant sales. Company restaurant margins are susceptible to fluctuations in commodity costs, labor costs and other operating costs such as utilities. Company restaurant margins were 9.1% and 11.0% in the 2007 quarter and the 2006 quarter, respectively, and 11.1% and 12.9% in the 2007 year-to-date period and the 2006 year-to-date period, respectively.
- o General and administrative expenses - general and administrative expenses expressed as a percentage of total operating revenues. General and administrative expenses were 11.0% and 11.3% in the 2007 quarter and the 2006 quarter, respectively, and 10.1% and 10.6% in the 2007 year-to-date period and the 2006 year-to-date period, respectively. Stock-based compensation included in general and administrative expenses was 1.4% and 1.6% in the 2007 quarter and the 2006 quarter, respectively, and 1.2% and 1.6% in the 2007 year-to-date period and the 2006 year-to-date period, respectively. We had expenses related to the exploration of strategic alternatives for enhancing shareholder value included in general and administrative expenses of approximately 1.3% and 0.7% in the 2007 quarter and the 2007 year-to-date period, respectively.

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- o Return on invested capital - net earnings expressed as a percent of average invested capital. We believe this is an important indicator as it allows us to evaluate our ability to create value for our shareholders.

Application of Critical Accounting Policies

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements, which were prepared in accordance with accounting principles generally accepted in the United States of America. These principles require us to make estimates and assumptions that affect the reported amounts in the condensed consolidated financial statements and notes thereto. Actual results may differ from these estimates, and such differences may be material to our condensed consolidated financial statements. We believe that the following accounting policies involve a significant degree of judgment or complexity:

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

We may periodically purchase and maintain inventories of certain specialty products to ensure sufficient supplies to the system, to ensure continuity of supply, or to control food costs. We review and make quality control inspections of our inventories to determine obsolescence on an ongoing basis. These reviews require management to make certain estimates and judgments regarding projected usage which may change in the future and may require us to record an inventory impairment.

Property and equipment: We report property and equipment at historical cost less accumulated depreciation. Depreciation is provided on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the lesser of the lease term or the estimated useful life of the related asset. The useful lives of the assets are based upon management's expectations. We periodically review the assets for changes in circumstances which may impact their useful lives. If there are changes in circumstances that revise an asset's useful life, we will adjust the depreciation expense accordingly for that asset in future periods.

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Stock-based compensation: We account for stock-based compensation in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123(R), "Share-Based Payment." As required by SFAS No. 123(R), stock-based compensation is estimated for equity awards at fair value at the grant date. We determine the fair value of equity awards using a binomial model. The binomial model requires various highly judgmental assumptions including the expected life, stock price volatility and the forfeiture rate. If any of the assumptions used in the model change significantly, stock-based compensation expense may differ materially in the future from that recorded in the current period.

Impairment and other restaurant closure costs: We periodically review restaurant property and equipment for impairment on a restaurant-by-restaurant basis using certain market and restaurant operating indicators including historical cash flows as well as current estimates of future cash flows and/or appraisals. We review other long-lived assets at least annually and when events or circumstances indicate that the carrying value of the asset may not be recoverable. The recoverability is assessed in most instances by comparing the carrying value to its undiscounted cash flows. This assessment process requires the use of estimates and assumptions regarding future cash flows and estimated useful lives, which are subject to a significant degree of judgment. If these

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assumptions change in the future, we may be required to record impairment charges for these assets.

We continually evaluate our restaurant portfolio and may determine to periodically close restaurants. At the time of each restaurant closing, we are required to record expenses and liabilities for the fair value of remaining lease payments less any potential sublease income. The amounts recorded require several estimates in determining the fair value. The actual amounts expensed after settlement with our landlords may be materially different from the amounts recorded.

Income taxes: We record valuation allowances against our deferred tax assets, when necessary, in accordance with SFAS No. 109, "Accounting for Income Taxes." Realization of deferred tax assets is dependent on future taxable earnings and is therefore uncertain. We assess the likelihood that our deferred tax assets in each of the jurisdictions in which we operate will be recovered from future taxable income. Deferred tax assets do not include future tax benefits that we deem likely not to be realized.

We are periodically audited by foreign and domestic tax authorities for both income and sales and use taxes. In 2006, we recorded accruals when we determined it was probable that we had an exposure in a matter relating to an audit.

In July 2006, the Financial Accounting Standards Board ("FASB") issued Interpretation ("FIN") No. 48, "Accounting for Uncertainty in Income Taxes," which became effective for us beginning in 2007. FIN No. 48 addresses the determination of how tax benefits claimed or expected to be claimed on a tax return should be recorded in the financial statements. Under FIN No. 48, we must recognize the tax benefit from an uncertain tax position only if it is more likely than not that the tax position will be sustained on examination by the taxing authorities, based on the technical merits of the position. Our estimates of the tax benefit from uncertain tax positions may change in the future due to new developments in each matter.

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

We use estimates in the determination of the appropriate liabilities for general liability, workers' compensation and health insurance. The estimated liability is established based upon historical claims data and third-party actuarial

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estimates of settlement costs for incurred claims. Unanticipated changes in these factors may require us to revise our estimates.

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

Acquisition

The acquisition discussed below has been accounted for using the purchase method of accounting and, accordingly, our condensed consolidated financial statements reflect the results of operations for the acquisition subsequent to the date of acquisition. The assets acquired and liabilities assumed are recorded at

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estimates of fair value as determined by management based upon information available.

In January 2006, we completed the acquisition of four Applebee's restaurants in the Houston market for approximately \$8,100,000 in cash. The purchase price was allocated to the fair value of property and equipment of \$7,400,000, goodwill of approximately \$500,000, reacquired franchise rights of approximately \$100,000, and other net assets of approximately \$100,000. The proforma impact on our results of operations was immaterial.

We finalize the allocation of purchase price to the fair value of assets acquired and liabilities assumed when we obtain information sufficient to complete the allocation, but in each case, no longer than one year after the acquisition date.

Captive Insurance Subsidiary

In 2002, we formed Neighborhood Insurance, Inc., a Vermont corporation and a wholly-owned captive insurance subsidiary to provide Applebee's International, Inc. and qualified franchisees with workers' compensation and general liability insurance. Through 2005, Applebee's International, Inc. and covered franchisees made premium payments to the captive insurance company which pays administrative fees and insurance claims, subject to individual and aggregate maximum claim limits under the captive insurance company's reinsurance policies. Franchisee premium amounts billed by the captive insurance company were established based upon third-party actuarial estimates of settlement costs for incurred and anticipated claims and administrative fees. In 2006, we discontinued writing insurance coverage for new or existing participants. Cost of other franchise income includes costs related to the resolution of claims arising from franchisee participation in our captive insurance program. We do not expect franchisee participation in the captive insurance company to have a material impact on our net earnings. Our consolidated balance sheets include the following balances related to the captive insurance subsidiary:

- o Franchise premium receivables of approximately \$200,000 and \$400,000 as of September 30, 2007 and December 31, 2006, respectively, included in receivables.
- o Cash equivalent and other long-term investments restricted for the payment of claims of approximately \$10,000,000 and \$12,600,000 as of September 30, 2007 and December 31, 2006, respectively, included in restricted assets related to captive insurance subsidiary.
- o Loss reserve related to captive insurance subsidiary of approximately \$8,100,000 and \$12,600,000 as of September 30, 2007 and December 31,

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2006, respectively. Approximately \$3,200,000 and \$6,500,000 for September 30, 2007 and December 31, 2006, respectively, is included in other non-current liabilities.

Results of Operations

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

2007

2006

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| | Quarter | Quarter | |
|---|---------|---------|-----|
| | ----- | ----- | --- |
| Operating revenues: | | | |
| Company restaurant sales..... | 89.2% | 89.3% | |
| Franchise royalties and fees..... | 10.6 | 10.6 | |
| Other franchise income..... | 0.1 | 0.1 | |
| | ----- | ----- | --- |
| Total operating revenues..... | 100.0% | 100.0% | |
| | ===== | ===== | === |
| Cost of sales (as a percentage of company restaurant sales): | | | |
| Food and beverage..... | 26.7% | 26.7% | |
| Labor..... | 35.3 | 34.4 | |
| Direct and occupancy..... | 28.8 | 27.6 | |
| Pre-opening expense..... | 0.1 | 0.4 | |
| | ----- | ----- | --- |
| Total cost of sales..... | 90.9% | 89.0% | |
| | ===== | ===== | === |
| Cost of other franchise income (as a percentage of other franchise income)..... | 75.2% | 187.1% | |
| General and administrative expenses..... | 11.0 | 11.3 | |
| Amortization of intangible assets..... | -- | -- | |
| Impairment and other restaurant closure costs..... | -- | 0.4 | |
| Loss on disposition of property and equipment..... | 0.2 | 0.2 | |
| | ----- | ----- | --- |
| Operating earnings..... | 7.5 | 8.3 | |
| | ----- | ----- | --- |
| Other income (expense): | | | |
| Investment income..... | 0.2 | 0.3 | |
| Interest expense..... | (0.6) | (0.9) | |
| Other income..... | -- | 0.1 | |
| | ----- | ----- | --- |
| Total other expense..... | (0.4) | (0.6) | |
| | ----- | ----- | --- |
| Earnings from continuing operations before income taxes..... | 7.1 | 7.8 | |
| Income taxes..... | 2.3 | 2.8 | |
| | ----- | ----- | --- |
| Earnings from continuing operations..... | 4.9 | 4.9 | |
| Loss from discontinued operations, net of tax..... | -- | (0.2) | |
| | ----- | ----- | --- |
| Net earnings..... | 4.9% | 4.7% | |
| | ===== | ===== | === |

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

| | 2007 Quarter | 2006 Quarter | 2007 Year-to-D Period |
|------------------------|-----------------|-----------------|-----------------------------|
| | ----- | ----- | ----- |
| Number of restaurants: | | | |

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| | | | |
|---|------------|------------|------------|
| Company: | | | |
| Beginning of period..... | 508 | 507 | 521 |
| Restaurant openings..... | 2 | 6 | 12 |
| Restaurant closings..... | -- | (1) | (23) |
| Restaurants acquired from franchisees... | -- | -- | -- |
| | ----- | ----- | ----- |
| End of period..... | 510 | 512 | 510 |
| | ----- | ----- | ----- |
| Franchise: | | | |
| Beginning of period..... | 1,435 | 1,353 | 1,409 |
| Restaurant openings..... | 14 | 22 | 42 |
| Restaurant closings..... | (6) | (3) | (8) |
| Restaurants acquired by franchisor..... | -- | -- | -- |
| | ----- | ----- | ----- |
| End of period..... | 1,443 | 1,372 | 1,443 |
| | ----- | ----- | ----- |
| Total: | | | |
| Beginning of period..... | 1,943 | 1,860 | 1,930 |
| Restaurant openings..... | 16 | 28 | 54 |
| Restaurant closings..... | (6) | (4) | (31) |
| | ----- | ----- | ----- |
| End of period..... | 1,953 | 1,884 | 1,953 |
| | ===== | ===== | ===== |
| Weighted average weekly sales per restaurant: | | | |
| Company(1)..... | \$ 43,720 | \$ 43,331 | \$ 44,501 |
| Domestic franchise..... | \$ 46,928 | \$ 47,516 | \$ 48,993 |
| Domestic total..... | \$ 46,046 | \$ 46,327 | \$ 47,744 |
| Change in comparable restaurant sales:(2) | | | |
| Company(3)..... | (0.2)% | (1.7)% | (2.0) |
| Domestic franchise..... | (0.4)% | (2.5)% | (1.7) |
| Domestic total..... | (0.3)% | (2.3)% | (1.8) |
| Total operating revenues (in thousands): | | | |
| Company restaurant sales(4)..... | \$ 288,861 | \$ 280,480 | \$ 883,128 |
| Franchise royalties and fees(5)..... | 34,357 | 33,340 | 107,651 |
| Other franchise income(6)..... | 475 | 371 | 1,209 |
| | ----- | ----- | ----- |
| Total..... | \$ 323,693 | \$ 314,191 | \$ 991,988 |
| | ===== | ===== | ===== |

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2007 Quarter Compared With 2006 Quarter and 2007 Year-to-Date Period Compared With 2006 Year-to-Date Period

Company Restaurant Sales. Total company restaurant sales increased \$8,381,000 (3%) from \$280,480,000 in the 2006 quarter to \$288,861,000 in the 2007 quarter and increased \$12,756,000 (1%) from \$870,372,000 in the 2006 year-to-date period to \$883,128,000 in the 2007 year-to-date period. The percentage increase in total company restaurant sales was due to an increase in the number of restaurant weeks open of approximately 4% in the 2007 quarter and 5% in the 2007 year-to-date period, excluding the 19 restaurants which have been presented as discontinued operations. The increase in both periods was partially offset by a decline in average weekly sales for restaurants presented in continuing operations.

Comparable restaurant sales at company restaurants decreased by 0.2% and 2.0% in the 2007 quarter and the 2007 year-to-date period, respectively. Weighted average weekly sales at company restaurants increased 0.9% from \$43,331 in the

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2006 quarter to \$43,720 in the 2007 quarter and decreased 2.3% from \$45,527 in the 2006 year-to-date period to \$44,501 in the 2007 year-to-date period. Average weekly sales were negatively impacted by declines in guest traffic of approximately 4.2% in both the 2007 quarter and the 2007 year-to-date period, as well as the underperformance of restaurants open less than 18 months. In addition, both periods were favorably impacted by a higher guest check related to our menu promotions and menu price increases of approximately 2.7%.

Franchise Royalties and Fees. Franchise royalties and fees increased \$1,017,000 (3%) from \$33,340,000 in the 2006 quarter to \$34,357,000 in the 2007 quarter and increased \$4,070,000 (4%) from \$103,581,000 in the 2006 year-to-date period to \$107,651,000 in the 2007 year-to-date period due primarily to the increased number of franchise restaurants operating during both periods as compared to the prior year. Domestic franchise weighted average weekly sales and comparable restaurant sales decreased 1.2% and 0.4%, respectively, in the 2007 quarter and decreased by 2.8% and 1.7%, respectively, in the 2007 year-to-date period.

Cost of Company Restaurant Sales. Food and beverage costs were 26.7% in both the 2006 quarter and the 2007 quarter and were 26.6% in both the 2006 year-to-date period and the 2007 year-to-date period. Food and beverage costs were unfavorably impacted in both periods by a shift in menu mix and higher food costs related to our menu promotions which were offset by menu price increases of approximately 2.7% in both the 2007 quarter and the 2007 year-to-date period. We currently expect net commodity costs to increase by approximately 1% in 2007.

Labor costs increased from 34.4% in the 2006 quarter to 35.3% in the 2007 quarter and increased from 33.5% in the 2006 year-to-date period to 34.6% in the 2007 year-to-date period due primarily to higher restaurant management salaries and hourly wage rates including the impact of state minimum wage rate increases, and higher vacation expense which was partially offset by better management of hourly staffing. In addition, the 2007 quarter was unfavorably impacted by higher group insurance expense and higher restaurant management incentive compensation. We currently expect labor costs to continue to be negatively impacted by recently enacted state hourly minimum wage increases in 2007.

Direct and occupancy costs increased from 27.6% in the 2006 quarter to 28.8% in the 2007 quarter and increased from 26.5% in the 2006 year-to-date period to 27.6% in the 2007 year-to-date period due primarily to lower sales volumes at company restaurants which resulted in unfavorable year-over-year comparisons for

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depreciation and rent, as a percentage of sales, due to their relatively fixed nature as well as higher repairs and maintenance, utilities and credit card usage expense. In addition, the 2007 quarter was unfavorably impacted by higher advertising expenses, as a percentage of sales and the 2007-year-to-date period was favorably impacted by lower kitchen and dining supplies expense.

General and Administrative Expenses. General and administrative expenses decreased from 11.3% in the 2006 quarter to 11.0% in the 2007 quarter and decreased from 10.6% in the 2006 year-to-date period to 10.1% in the 2007 year-to-date period due primarily to lower stock-based compensation which decreased \$600,000 in the 2007 quarter and \$4,000,000 in the 2007 year-to-date period as well as the favorable impact of a \$1,500,000 legal expense recorded in the third quarter of fiscal 2006 related to the settlement of a California wage and hour lawsuit. The decrease was partially offset by expenses related to the exploration of strategic alternatives for enhancing shareholder value in both periods, as well as expenses in the 2007 year-to-date period related to a proxy contest, which totaled approximately \$4,000,000 in the 2007 quarter and approximately \$7,500,000 in the 2007 year-to-date period.

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Impairment and Other Restaurant Closure Costs. Impairment and other restaurant closure costs decreased from \$1,296,000 in the 2006 quarter to \$74,000 in the 2007 quarter and increased from \$2,416,000 in the 2006 year-to-date period to \$5,830,000 in the 2007 year-to-date period. The increase in the 2007 year-to-date period was due to the decision to close 24 underperforming restaurants as discussed below.

In March 2007, we announced that the Board of Directors had approved management's recommendation to close 24 underperforming restaurants located in 11 states which we determined did not have the potential to deliver acceptable long-term returns on invested capital. We closed 19 restaurants in the first fiscal quarter of 2007 and four restaurants in the second quarter of fiscal 2007, leaving one of the 24 underperforming restaurants still open.

Investment Income. Investment income decreased from \$885,000 in the 2006 quarter to \$746,000 in the 2007 quarter and increased from \$1,345,000 in the 2006 year-to-date period to \$2,753,000 in the 2007 year-to-date period. The increase in the 2007 year-to-date period was due primarily to an increase in the return on investments in our deferred compensation plan investments.

Interest Expense. Interest expense decreased from \$2,970,000 in the 2006 quarter to \$1,945,000 in the 2007 quarter and from \$8,509,000 in the 2006 year-to-date period to \$6,670,000 in the 2007 year-to-date period due to a decrease in the amount of borrowings outstanding under our revolving credit facility.

Income Taxes. The effective income tax rate, as a percentage of earnings from continuing operations before income taxes, decreased from 36.3% in the 2006 quarter to 31.7% in the 2007 quarter and decreased from 34.7% in the 2006 year-to-date period to 32.6% in the 2007 year-to-date period due to the impact of discontinued operations, the impact of higher tax credits related to the construction of our new corporate headquarters and higher employment credits all of which were over a lower taxable income base as compared to 2006.

Earnings from Continuing Operations. Earnings from continuing operations increased \$293,000 (2%) from \$15,513,000 in the 2006 quarter to \$15,806,000 in the 2007 quarter and decreased \$2,943,000 (4%) from \$66,015,000 in the 2006 year-to-date period to \$63,072,000 in the 2007 year-to-date period. The decrease in the 2007 year-to-date period was due primarily to impairment and other restaurant closure costs of approximately \$5,800,000 incurred in the 2007 year-to-date period related to four restaurants closed which have been presented in continuing operations.

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Loss from Discontinued Operations, Net of Tax. The loss from discontinued operations decreased \$630,000 from a loss of \$672,000 in the 2006 quarter to a loss of \$42,000 in the 2007 quarter and increased \$10,065,000 from a loss of \$3,619,000 in the 2006 year-to-date period to a loss of \$13,684,000 in the 2007 year-to-date period. The decrease in the loss in the 2007 quarter was due to the write down of the carrying value of property and equipment in the 2006 quarter which has been presented as discontinued operations. The increase in the loss in the 2007 year-to-date period was due primarily to a write-down of the carrying value of property and equipment and other assets of approximately \$11,900,000, lease obligations for closed restaurants and other costs of approximately \$9,600,000, loss from restaurant operations of approximately \$600,000 and a gain on the sale of property and equipment of approximately \$600,000 (approximately \$13,700,000 net of tax for all items) which are related to the 19 restaurants presented as discontinued operations.

Net Earnings. Net earnings increased \$923,000 (6%) from \$14,841,000 in the 2006 quarter to \$15,764,000 in the 2007 quarter and decreased \$13,008,000 (21%) from

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\$62,396,000 in the 2006 year-to-date period to \$49,388,000 in the 2007 year-to-date period. The decrease in the 2007 year-to-date period was due primarily to discontinued operations of approximately \$13,700,000, net of tax, and impairment and other restaurant closure costs of approximately \$5,800,000 incurred related to the decision to close 24 restaurants.

Liquidity and Capital Resources

Our primary sources of liquidity are cash provided by operations and borrowings under our credit facility. Our need for capital resources historically has resulted from the construction and acquisition of restaurants, refurbishment and capital replacement for existing restaurants, the repurchase of our common stock and investment in information technology systems. We obtain capital through our ongoing operations and debt financing.

Cash flows from our operating activities primarily include the net cash generated from company and franchise operations and management of credit from trade suppliers. Cash flows provided or used by investing activities include capital expenditures for restaurant construction, refurbishment, information technology, acquisitions of franchise restaurants, sale-leaseback transactions and asset sales. Cash flows provided or used by financing activities include borrowings and repayments of debt, repurchases of our common stock, dividends to shareholders and the cash received from the exercise of employee stock options. The following table presents a summary of our cash flows for the 2007 year-to-date period and the 2006 year-to-date period (in thousands):

| | 2007 Year-to-Date Period | 2006 Year-to-Date Period |
|--|--------------------------------|--------------------------------|
| Net cash provided by operating activities..... | \$ 116,474 | \$ 109,438 |
| Net cash used by investing activities..... | (57,726) | (90,089) |
| Net cash used by financing activities..... | (62,145) | (22,613) |
| Net decrease in cash and cash equivalents..... | \$ (3,397) | \$ (3,264) |

Capital expenditures were \$65,276,000 in the 2007 year-to-date period and \$86,635,000 in the 2006 year-to-date period.

Excluding costs related to the construction of our new corporate headquarters, capital expenditures are expected to be between \$60,000,000 and \$70,000,000 in 2007 and will primarily be for the development of new restaurants, refurbishment and capital replacement for existing restaurants and the enhancement of information systems. Costs for the new corporate headquarters are expected to be approximately \$35,000,000 in 2007. We intend to enter into a sale-leaseback transaction with respect to the new headquarters upon its completion or thereafter, depending upon market conditions. We currently expect to open between 13 and 15 company restaurants in 2007. We expect to continue to purchase a portion of our restaurant sites; however the amount of actual capital expenditures will be dependent upon, among other things, the proportion of leased versus owned properties. If we construct more or fewer restaurants than

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we currently anticipate, or acquire additional restaurants, our capital requirements will increase or decrease accordingly.

In January 2006, we completed the acquisition of four Applebee's restaurants in the Houston area for approximately \$8,100,000 in cash.

In December 2006, we entered into a five-year revolving credit facility. The terms of the bank credit agreement provide for \$400,000,000 in unsecured revolving credit as well as an additional \$200,000,000 of revolving credit upon satisfaction of the conditions set forth in the credit facility. The facility is subject to various covenants and restrictions which, among other things, require the maintenance of stipulated fixed charge and leverage ratios, as defined. There is no limit on cash dividends or repurchases of our common stock provided the declaration and payment of such dividend or repurchase of stock does not cause a default of any other covenant contained in the agreement. The facility is subject to other standard terms, conditions, covenants and fees. As of September 30, 2007, we were in compliance with the covenants contained in our credit agreement. We had borrowings of \$118,000,000, standby letters of credit of approximately \$20,300,000 outstanding and approximately \$261,700,000 available under our revolving credit facility as of September 30, 2007.

In November 2006, with approximately \$100,000,000 of a previous authorization remaining, our Board of Directors authorized additional repurchases of our common stock of up to \$150,000,000, subject to market conditions, for a total of approximately \$250,000,000 in authorized repurchases. During the 2007 year-to-date period, we repurchased 42,000 shares of our common stock at an average price of \$23.93 for an aggregate cost of approximately \$1,000,000. As of September 30, 2007, we had approximately \$239,400,000 remaining under our repurchase authorizations.

In December 2006, the Board of Directors declared an annual dividend of \$0.22 per share payable to shareholders of record on December 22, 2006. We paid approximately \$16,300,000 in January 2007 related to this dividend. We are precluded from stock repurchases and the payment of any dividends under the terms of the agreement with IHOP.

As of September 30, 2007, our liquid assets totaled \$19,211,000. These assets consisted of cash and cash equivalents in the amount of \$18,912,000 and short-term investments in the amount of \$299,000.

Historically, we operate with working capital deficits as we carry low levels of accounts receivable and most of our revenues are received in cash or credit cards at the time of sale. We have used this cash to purchase property and equipment, repurchase our common stock and pay down long-term debt, all of which are non-current in nature. The working capital deficit decreased from \$81,626,000 as of December 31, 2006 to \$48,467,000 as of September 30, 2007. This decrease resulted primarily from a combination of factors which included decreases in receivables and accrued dividends, an increase in accounts payable,

payments on debt, the reclassification of certain property and equipment to assets held for sale, and higher redemption of gift cards as compared to the sales of gift cards.

We believe that our liquid assets and cash generated from operations, combined with available borrowings, will provide sufficient funds for operating activities, capital expenditures, currently approved repurchases of our common stock and the payment of dividends for at least the next 12 months and thereafter for the foreseeable future.

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The following table shows our debt amortization schedule, future capital lease commitments (including principal and interest payments), future operating lease commitments and future purchase obligations as of September 30, 2007 (in thousands):

| Certain Contractual Obligations(1) | Payments due by period | | |
|--|------------------------|---------------------|--------------|
| | Total | Less than 1 year | 1-3 years |
| Long-term Debt (excluding capital lease obligations) (2)..... | \$ 119,225 | \$ 42 | \$ 97 |
| Capital Lease Obligations..... | 6,924 | 843 | 1,776 |
| Operating Leases (3)..... | 403,243 | 30,571 | 60,007 |
| Purchase Obligations - Company(4)..... | 116,982 | 92,123 | 24,859 |
| Purchase Obligations - Franchise(5)..... | 270,851 | 200,513 | 70,338 |

Other Contractual Obligations

In June 2007, we entered into a capital lease with the City of Lenexa, Kansas in association with the development of our new corporate headquarters. As of September 30, 2007, our lease obligation is \$4,500,000. In accordance with Financial Accounting Standards Board ("FASB") Interpretation Number 39, "Offsetting of Amounts Related to Certain Contracts" ("FIN 39"), our lease obligation has been offset against \$4,500,000 of related industrial revenue bonds issued by the City of Lenexa, Kansas and purchased by us.

In connection with the sale of restaurants to franchisees and other parties, we have, in certain cases, remained contingently liable for the remaining lease payments. As of September 30, 2007, we have outstanding lease guarantees of approximately \$13,900,000. In addition, we or our subsidiaries are contingently liable for various leases that we have assigned in connection with the sale of restaurants to franchisees and other parties in the potential amount of \$11,100,000. These leases expire at various times with the final lease agreement expiring in 2018. The sale of virtually all of the restaurants involving these lease contingencies occurred prior to the effective date of FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45") and,

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therefore, we were not required to record a liability for these guarantees following the prospective application guidance. The fair value of the few remaining lease guarantees entered into after the date of adoption are immaterial to our consolidated financial statements, thus we did not record a liability related to these contingent lease liabilities as of September 30, 2007 or December 31, 2006.

In 2004, we arranged for a third-party financing company to provide up to \$250,000,000 to qualified franchisees for loans to fund development of new restaurants through October 2007, subject to our approval. We will provide a limited guarantee of 10% of certain loans advanced under this program. We will be released from our guarantee if certain operating results are met after the restaurant has been open for at least two years. As of September 30, 2007, there were loans outstanding to five franchisees for approximately \$34,900,000, net of any guarantees in which we were released, under this program. The fair value of

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our guarantees under this financing program is approximately \$100,000 and is recorded in non-current liabilities in our consolidated balance sheet as of September 30, 2007. This program will expire on October 31, 2007.

We have severance and employment agreements with certain officers providing for severance payments to be made in the event the officer resigns or is terminated not related to a change in control, some of which require payments to be made only if we enforce certain terms in the agreements. If the severance payments had been due as of September 30, 2007, we would have been required to make payments totaling approximately \$10,400,000. In addition, we have severance and employment agreements with certain officers which contain severance provisions related to a change in control. The agreements define the circumstances which will constitute a change in control. Those provisions would have required additional aggregate payments of approximately \$6,400,000 if such officers had been terminated as of September 30, 2007.

New Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This statement defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosures about fair value measurements. The statement applies whenever other statements require or permit assets or liabilities to be measured at fair value. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. The impact of this adoption will not be material to our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." This statement requires companies to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. The statement requires prospective application, and the recognition and disclosure requirements are effective for companies with fiscal years ending after December 15, 2006. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. The impact of this adoption was not material to our consolidated financial statements and we are in compliance with the measurement date provisions of this statement.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Liabilities." This statement permits entities to choose to measure many financial instruments and certain other items at fair value. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. SFAS No. 159 is effective for fiscal

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years beginning after November 15, 2007. We are currently evaluating the impact of this adoption on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risk from fluctuations in interest rates and changes in commodity prices. Our revolving credit facility bears interest at either the bank's prime rate or LIBOR plus 0.45%, at our option. As of September 30, 2007, the total amount of debt subject to interest rate fluctuations was \$118,000,000, which was outstanding on our revolving credit facility. A 1% change in interest rates would result in an increase or decrease in interest expense of approximately \$1,200,000 per year. We may from time to time enter into interest rate swap agreements to manage the impact of interest rate changes on our earnings. A substantial portion of the food products and utilities we purchase

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are subject to price volatility due to factors that are outside of our control such as weather, seasonality and fuel costs. As part of our strategy to moderate this volatility, we have entered into fixed price purchase commitments.

Item 4. Controls and Procedures

As of September 30, 2007, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures, under the supervision and with the participation of the Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"). Based on this evaluation, our management, including the CEO and CFO, concluded that our disclosure controls and procedures are effective.

During the 2007 quarter, there have been no changes in our internal control over financial reporting that occurred that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are subject from time to time to lawsuits, claims and governmental inspections or audits arising in the ordinary course of business. Some of these lawsuits purport to be class actions and/or seek substantial damages. In the opinion of management, these matters are adequately covered by insurance, or if not so covered, are without merit or are of such a nature or involve amounts that would not have a material adverse impact on our business or consolidated financial position.

On July 26, 2007, the New Jersey Building Laborers Pension and Annuity Funds filed a putative class action complaint in the Court of Chancery of the State of Delaware for New Castle County against Applebee's International, Inc., its directors, and IHOP Corporation. On September 14, 2007, the plaintiff in this matter filed an amended complaint against the same defendants. The amended complaint alleges, among other things, that the proposed transaction with IHOP is unfair to Applebee's stockholders. As relief, the amended complaint seeks to enjoin the transaction and seeks monetary damages in an unspecified amount. The parties have agreed in principle to a disclosure-based settlement described in a Memorandum of Understanding which was submitted to the Court on October 12, 2007. The proposed settlement is subject to, among other things, confirmatory discovery by plaintiffs, notice to the putative class members and approval by the Court.

We are currently defending a collective action filed under the Fair Labor Standards Act styled Gerald Fast v. Applebee's International, Inc., in which named plaintiffs claim that tipped workers in company restaurants perform excessive amounts of non-tipped work for which they should be compensated at the minimum wage. The court has conditionally certified a nationwide class of servers and bartenders who have worked in company-owned restaurants since June 19, 2004. Unlike a class action, a collective action requires potential class members to "opt in" rather than "opt out." Therefore, the number of class members will not be known until the end of 2007, when the opt in period expires. Conditional certification is granted under a lenient standard and the company will have an opportunity to have the class de-certified following the close of discovery at the end of 2008. The company believes it has strong defenses supporting the de-certification of the class, as well as strong defenses to the

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substantive claims asserted, and intends to vigorously defend this case. An estimate of the possible loss, if any, or the range of the loss cannot be made and therefore, the Company has not accrued a loss contingency related to this matter.

Item 1A. Risk Factors

There have been no material changes in our risk factors from those disclosed in our 2006 Annual Report on Form 10-K and Quarterly Report on Form 10-Q for the fiscal quarter ended July 1, 2007, except as listed below.

A significant increase in litigation could have a material adverse effect on our results of operations, financial condition and business prospects.

We are subject to complaints or litigation from guests alleging illness, injury or other food quality, health or operational concerns. Adverse publicity resulting from these allegations could harm the operation and profitability of our restaurants, regardless of whether the allegations are valid, whether we are liable or whether the claim involves our restaurants or one of our franchisees.

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Failure to comply with the various federal and state labor laws pertaining to minimum wage, overtime pay, meal and rest breaks, unemployment tax rates, workers' compensation rates, citizenship or residency requirements, child labor requirements and sales taxes may have a material adverse effect on our business or operations. In particular, we are party to a number of employment-related and wage-related lawsuits, including a collective action suit filed in July 2006 in a U.S. federal court in Missouri relating to minimum wage and tip credit for past and present servers and bartenders of our restaurants whose minimum wage calculation included "tip credit". The plaintiffs allege, among other things, that Applebee's International, Inc. violated the Fair Labor Standards Act of 1938 by failing to pay the legally mandated minimum wage for work such as general preparation or maintenance work, for which the employees did not earn tips. We are actively defending against the case, and intend to seek decertification of the class, which is expected to be heard in early 2009 following discovery proceedings. Since the case is at a very preliminary stage, we cannot currently make an estimate as to the chance of success for the plaintiffs or the magnitude of our liability associated with the case, if the class is not decertified and is decided against Applebee's International, Inc. If the case is decided against us, significant changes to the timekeeping systems of our restaurants or increases in employee wage rates may be required. If we incur losses as a result of employment liabilities, our business and operations will be adversely affected.

Further, employee claims based on, among other things, discrimination, harassment or wrongful termination may divert our financial and management resources and adversely affect our operations.

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

(c) Issuer Purchases of Equity Securities.

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| Purchases of Equity Securities(1) | | | | |
|--|----------------------------------|------------------------------|--|------------------------------|
| | (a) | (b) | (c) | |
| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Shares Purchased (1) |
| July 2, 2007 through July 29, 2007 | -- | -- | -- | |
| July 30, 2007 through August 26, | -- | -- | -- | |
| August 27, 2007 through September 30, 2007 | -- | -- | -- | |
| Total | -- | -- | -- | |

Item 6. Exhibits

The Exhibits listed on the accompanying Exhibit Index are filed as part of this report.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

APPLEBEE'S INTERNATIONAL, INC.
(Registrant)

Date: October 29, 2007 By: /s/ David L. Goebel

David L. Goebel
Director, President and Chief Executive Officer
(principal executive officer)

Date: October 29, 2007 By: /s/ Steven K. Lumpkin

Steven K. Lumpkin
Director, Executive Vice President,
Chief Financial and Strategy Officer
(principal financial officer)

Date: October 29, 2007 By: /s/ Beverly O. Elving

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Beverly O. Elving
Vice President and Controller
(principal accounting officer)

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APPLEBEE'S INTERNATIONAL, INC.
EXHIBIT INDEX

| Exhibit Number | Description of Exhibit |
|-------------------|--|
| 2.1 | Agreement and Plan of Merger dated July 15, 2007, among IHOP Corp., CHLH Corp. and Applebee's International, Inc. (incorporated by reference to Exhibit 2.1 of the Registrant's Form 8-K filed July 18, 2007). |
| 31.1 | Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14(a). |
| 31.2 | Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14(a). |
| 32.1 | Certification Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

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