SONIC CORP
Form 10-Q
January 09, 2009

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

FORM 10-Q

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

For the quarterly period ended: November 30, 2008

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 0-18859

SONIC CORP.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State of incorporation) | 73-1371046<br>(I.R.S. Employer Identification No.) |
| 300 Johnny Bench Drive<br>Oklahoma City, Oklahoma<br>(Address of principal executive offices) | 73104<br>Zip Code |

Registrant's telephone number, including area code: (405) 225-5000

Indicate by check mark whether the registrant (1) has filed all reports required 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 the reports), and (2) has been subject to such filing requirements for the past 90 days. Yes T. No £

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

Large accelerated filer T. Accelerated filer £. Non-accelerated filer £. Smaller reporting company £

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

As of November 30, 2008, the Registrant had 60,561,902 shares of common stock issued and outstanding (excluding 56,600,080 shares of common stock held as treasury stock).

SONIC CORP.
Index

Index

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

SONIC CORP.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)

| ASSETS | (Unaudited) November 30, 2008 | August 31, 2008 |
|---|---|---|
| Current assets: | | |
| Cash and cash equivalents | $ 45,863 | $ 44,266 |
| Restricted cash | 16,875 | 14,934 |
| Accounts and notes receivable, net | 24,218 | 29,838 |
| Other current assets | 9,887 | 10,389 |
| Total current assets | 96,843 | 99,427 |
| | | |
| Property, equipment and capital leases | 841,409 | 844,345 |
| Less accumulated depreciation and amortization | (268,484) | (258,100) |
| Property, equipment and capital leases, net | 572,925 | 586,245 |
| | | |
| Goodwill, net | 105,600 | 105,762 |
| Trademarks, trade names and other intangible assets, net | 12,255 | 12,418 |
| Noncurrent restricted cash | 10,922 | 11,192 |
| Investment in direct financing leases and noncurrent portion of notes receivable | 4,540 | 4,764 |
| Debt origination costs and other assets, net | 15,386 | 16,504 |
| Intangibles and other assets, net | 148,703 | 150,640 |
| Total assets | $ 818,471 | $ 836,312 |
| | | |
| LIABILITIES AND STOCKHOLDERS’ DEFICIT | | |
| Current liabilities: | | |
| Accounts payable | $ 17,692 | $ 20,762 |
| Deposits from franchisees | 2,409 | 3,213 |
| Accrued liabilities | 32,836 | 46,200 |
| Income taxes payable | 6,349 | 1,016 |
| Obligations under capital leases and long-term debt due within one year | 46,591 | 41,351 |
| Total current liabilities | 105,877 | 112,542 |
| | | |
| Obligations under capital leases due after one year | 34,404 | 34,503 |
| Long-term debt due after one year | 699,162 | 720,953 |
| Other noncurrent liabilities | 33,719 | 32,430 |
| | | |
| Stockholders’ deficit: | | |
| Preferred stock, par value $.01; 1,000,000 shares authorized; none outstanding | – | – |
| Common stock, par value $.01; 245,000,000 shares authorized; 117,161,982 shares issued (117,004,879 shares issued at August 31, 2008) | 1,171 | 1,170 |

| | | |
|---|---|---|
| Paid-in capital | 211,450 | 209,316 |
| Retained earnings | 607,087 | 599,956 |
| Accumulated other comprehensive income | (2,032) | (2,191) |
| | 817,676 | 808,251 |
| Treasury stock, at cost; 56,600,080 common shares | (872,367) | (872,367) |
| Total stockholders' deficit | (54,691) | (64,116) |
| Total liabilities and stockholders' deficit | $ 818,471 | $ 836,312 |

See accompanying notes.

Index

SONIC CORP.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)

| | (Unaudited) Three months ended November 30, 2008 | 2007 |
|---|---|---|
| Revenues: | | |
| Partner Drive-In sales | $ 153,047 | $ 159,285 |
| Franchise Drive-Ins: | | |
| Franchise royalties | 29,055 | 28,639 |
| Franchise fees | 1,171 | 1,240 |
| Other | 793 | 1,017 |
| | 184,066 | 190,181 |
| Costs and expenses: | | |
| Partner Drive-Ins: | | |
| Food and packaging | 42,424 | 41,078 |
| Payroll and other employee benefits | 49,863 | 49,316 |
| Minority interest in earnings of Partner Drive-Ins | 3,825 | 5,296 |
| Other operating expenses, exclusive of depreciation and amortization included below | 34,523 | 33,484 |
| | 130,635 | 129,174 |
| | | |
| Selling, general and administrative | 16,162 | 14,914 |
| Depreciation and amortization | 13,019 | 12,206 |
| Provision for impairment of long-lived assets | 414 | – |
| | 160,230 | 156,294 |
| | | |
| Income from operations | 23,836 | 33,887 |
| | | |
| Interest expense | 12,053 | 12,669 |
| Interest income | (387) | (689) |
| Net interest expense | 11,666 | 11,980 |
| Income before income taxes | 12,170 | 21,907 |
| Provision for income taxes | 5,039 | 8,324 |
| Net income | $ 7,131 | $ 13,583 |
| | | |
| Net income per share – basic | $ 0.12 | $ 0.22 |
| | | |
| Net income per share – diluted | $ 0.12 | $ 0.22 |

See accompanying notes.

Index

SONIC CORP.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

| | (Unaudited) Three months ended November 30, 2008 | 2007 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 7,131 | $ 13,583 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 13,019 | 12,206 |
| Stock-based compensation expense | 1,806 | 1,861 |
| Other | 1,219 | 598 |
| Decrease in operating assets | 3,284 | 6,914 |
| Decrease in operating liabilities | (8,134) | (5,778) |
| Total adjustments | 11,194 | 15,801 |
| Net cash provided by operating activities | 18,325 | 29,384 |
| | | |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (15,113) | (20,988) |
| Acquisition of businesses, net of cash received | – | (6,288) |
| Proceeds from sale of assets | 14,354 | 3,068 |
| Proceeds from sale of minority interests in Partner Drive-Ins | 1,746 | 1,034 |
| Purchases of minority interests in Partner Drive-Ins | (3,041) | (1,602) |
| Other | 277 | (235) |
| Net cash used in investing activities | (1,777) | (25,011) |
| | | |
| Cash flows from financing activities: | | |
| Payments on long-term debt | (16,620) | (42,790) |
| Proceeds from long-term borrowings | – | 67,000 |
| Purchases of treasury stock | – | (26,674) |
| Proceeds from exercise of stock options | 708 | 2,238 |
| Other | 961 | (883) |
| Net cash used in financing activities | (14,951) | (1,109) |
| | | |
| Net increase in cash and cash equivalents | 1,597 | 3,264 |
| Cash and cash equivalents at beginning of period | 44,266 | 25,425 |
| Cash and cash equivalents at end of period | $ 45,863 | $ 28,689 |
| | | |
| Supplemental Cash Flow Information: | | |
| Additions to capital lease obligations | $ 669 | $ – |

See accompanying notes.

Index

SONIC CORP.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except per share data)

1. Basis of Presentation

The unaudited Condensed Consolidated Financial Statements include all adjustments, consisting of normal, recurring accruals, which Sonic Corp. (the "Company") considers necessary for a fair presentation of the financial position and the results of operations for the indicated periods. In certain situations, these accruals, including franchise royalties, are based on more limited information at interim reporting dates than at the Company's fiscal year end due to the abbreviated reporting period. Actual results may differ from these estimates. The notes to the condensed consolidated financial statements should be read in conjunction with the notes to the consolidated financial statements contained in the Company's Form 10-K for the fiscal year ended August 31, 2008. The results of operations for the three months ended November 30, 2008, are not necessarily indicative of the results to be expected for the full year ending August 31, 2009.

2. Net Income per Share

The following table sets forth the computation of basic and diluted earnings per share:

| | Three months ended November 30, 2008 | 2007 |
|---|---|---|
| Numerator: | | |
| Net income | $ 7,131 | $ 13,583 |
| Denominator: | | |
| Weighted average shares outstanding – basic | 60,459 | 60,772 |
| Effect of dilutive employee stock options | 751 | 2,293 |
| Weighted average shares – diluted | 61,210 | 63,065 |
| | | |
| Net income per share – basic | $ .12 | $ .22 |
| | | |
| Net income per share – diluted | $ .12 | $ .22 |

3. Contingencies

The Company is involved in various legal proceedings and has certain unresolved claims pending. Based on the information currently available, management believes that all claims currently pending are either covered by insurance or would not have a material adverse effect on the Company's business or financial condition.

The Company entered into an agreement with Irwin Franchise Capital Corporation ("Irwin") in September 2006, pursuant to which existing Sonic franchisees may qualify with Irwin to finance drive-in retrofit projects. The agreement originally provided that Sonic will guarantee at least $250 of such financing, limited to 5% of the aggregate amount of loans, not to exceed $2,500. In October 2008, the agreement was amended to increase the aggregate limit to a level not to exceed $3,750. As of November 30, 2008, the total amount guaranteed under the Irwin agreement was $826. The agreement provides for release of Sonic's guarantee on individual loans under the program that meet certain payment history criteria at the mid-point of each loan's term. Existing loans under the program have terms through 2015. In the event of default by a franchisee, the Company is obligated to pay Irwin the outstanding balances, plus limited interest and charges up to Sonic's guarantee limitation. Irwin is obligated to pursue collections as if Sonic's guarantee were not in place, therefore, providing recourse with the franchisee under the notes. The Company's liability for this guarantee, which is based on fair value, is $330 as of November 30, 2008.

Index

The Company has an agreement with GE Capital Franchise Finance Corporation ("GEC") pursuant to which GEC made loans to existing Sonic franchisees who met certain underwriting criteria set by GEC. Under the terms of the agreement with GEC, the Company provided a guarantee of 10% of the outstanding balance of loans from GEC to the Sonic franchisees, limited to a maximum amount of $5,000. As of November 30, 2008, the total amount guaranteed under the GEC agreement was $1,498. The Company ceased guaranteeing new loans under the program during fiscal year 2002 and has not been required to make any payments under its agreement with GEC. Existing loans under guarantee will expire through 2012. In the event of default by a franchisee, the Company has the option to fulfill the franchisee's obligations under the note or to become the note holder, which would provide an avenue of recourse with the franchisee under the notes. Based on the ending date for this program, no liability is required for these guarantees.

The Company has obligations under various lease agreements with third party lessors related to the real estate for Partner Drive-Ins that was sold to franchisees. Under these agreements, the Company remains secondarily liable for the lease payments for which it was responsible as the original lessee. As of November 30, 2008, the amount remaining under guaranteed lease obligations for which no liability has been provided totaled $5,659. In addition, capital lease obligations totaling $1,003 are still reflected as liabilities as of November 30, 2008 for properties sold to franchisees. At this time, the Company has no reason to anticipate any default under the foregoing leases.

Effective November 30, 2005, the Company extended a note purchase agreement to a bank that serves to guarantee the repayment of a franchisee loan and also benefits the franchisee with a lower financing rate. In the event of default by the franchisee, the Company would purchase the franchisee loan from the bank, thereby becoming the note holder and providing an avenue of recourse with the franchisee. As of November 30, 2008, the balance of the loan was $940.

4. Debt and Other Comprehensive Income

We previously disclosed that Moody's had placed under review for a possible downgrade the credit rating of our third-party insurance company that provides credit enhancements in the form of financial guaranties of our fixed and variable rate note payments. On November 5, 2008, Moody's downgraded the insurer's credit rating to Baa1. We are unable to determine whether further downgrades by Moody's or Standard & Poor's may occur and what impact this downgrade has had or further downgrades would have on our insurer's financial condition. For information regarding the consequences if the insurance company were to become the subject of insolvency or similar proceedings, see Note 9 of the Notes to Consolidated Financial Statements in our Annual Report on Form 10-K for the year ended August 31, 2008.

In August 2006, the Company entered into a forward starting swap agreement with a financial institution to hedge part of the exposure to changing interest rates for debt until it was settled in conjunction with financing closed in December 2006. The forward starting swap was designated as a cash flow hedge. The loss resulting from settlement was recorded in accumulated other comprehensive income and is being amortized to interest expense over the expected term of the related debt.

The following table presents the components of comprehensive income:

| | Three months ended November 30, | |
|---|---|---|
| | 2008 | 2007 |
| Net Income | $ 7,131 | $ 13,583 |
| Change in deferred hedging loss, net of tax | 159 | 166 |
| Total comprehensive income | $ 7,290 | $ 13,749 |

5. Segment Information

FASB Statement No. 131, “Disclosures about Segments of an Enterprise and Related Information” (“FAS 131”) establishes annual and interim reporting standards for an enterprise’s operating segments. Operating segments are generally defined as components of an enterprise about which separate discrete financial information is available as the basis for management to allocate resources and assess performance.

Index

Based on internal reporting and management structure, the Company has determined that it has two reportable segments: Partner Drive-Ins and Franchise Operations. The Partner Drive-Ins segment consists of the drive-in operations in which the Company owns a majority interest and derives its revenues from operating drive-in restaurants. The Franchise Operations segment consists of franchising activities and derives its revenues from royalties and initial franchise fees received from franchisees. The accounting policies of the segments are the same as those described in the Summary of Significant Accounting Policies in our most recent Annual Report on Form 10-K. Segment information for total assets and capital expenditures is not presented as such information is not used in measuring segment performance or allocating resources between segments.

The following table presents the revenues and income from operations for each reportable segment, along with reconciliation to reported revenue and income from operations:

| | Three months ended November 30, 2008 | Three months ended November 30, 2007 |
|---|---|---|
| Revenues: | | |
| Partner Drive-Ins | $ 153,047 | $ 159,285 |
| Franchise Operations | 30,226 | 29,879 |
| Unallocated revenues | 793 | 1,017 |
| | $ 184,066 | $ 190,181 |
| | | |
| Income from Operations: | | |
| Partner Drive-Ins | $ 22,412 | $ 30,111 |
| Franchise Operations | 30,226 | 29,879 |
| Unallocated revenues | 793 | 1,017 |
| Unallocated expenses: | | |
| Selling, general and administrative | (16,162) | (14,914) |
| Depreciation and amortization | (13,019) | (12,206) |
| Provision for impairment of long-lived assets | (414) | – |
| | $ 23,836 | $ 33,887 |

6. Fair Value Measures

We adopted FASB Statement No. 157, “Fair Value Measures” (“SFAS 157”), for financial assets and liabilities as of the beginning of fiscal year 2009. SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. SFAS 157 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 — Quoted prices in active markets for identical assets or liabilities;

Level 2 — Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities; and

Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

As of November 30, 2008, the Company's financial assets that are measured at fair value on a recurring basis consisted of $43,949, $16,875 and $10,922 million of short-term investments (Level 1) recorded in cash and cash equivalents, current restricted cash and noncurrent resricted cash, respectively. The Company has no financial liabilities that are required to be measured at fair value on a recurring basis.

In accordance with SFAS 157-2, the Company continues to evaluate the potential impact of applying the provisions of SFAS 157 to its non-financial assets and liabilities beginning in fiscal year 2010.

Index

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" ("SFAS 159"). SFAS 159 permits companies to choose to measure many financial instruments and certain other items at fair value and is effective for our current fiscal year. If the fair value option is elected, unrealized gains and losses will be recognized in earnings at each subsequent reporting date. The Company did not elect to begin reporting any financial assets or liabilities at fair value upon adoption of SFAS 159; therefore, the standard did not have any effect on the condensed consolidated financial statements.

7. Recently Issued Accounting Pronouncements

In December 2007, the FASB issued FASB Statement No. 141(revised 2007), "Business Combinations" ("SFAS 141(R)"). This standard retains the fundamental requirements in SFAS No. 141 that the acquisition method of accounting be used for all business combinations and for an acquirer to be identified for each business combination. SFAS 141(R) requires an acquirer to recognize the assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their fair values at the acquisition date. Costs incurred by the acquirer to effect the acquisition are not allocated to the assets acquired or liabilities assumed, but are recognized separately. SFAS 141(R) is effective prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008, which for us will be business combinations with an acquisition date beginning on or after September 1, 2009. The Company is evaluating the impact that SFAS 141(R) will have on its consolidated financial position and results of operations.

In December 2007, the FASB issued FASB Statement No. 160, "Noncontrolling Interests in Consolidated Financial Statements, an amendment to ARB No. 51" ("SFAS 160"). This standard establishes accounting and reporting standards for the noncontrolling interest in a subsidiary and for the deconsolidation of a subsidiary and clarifies that a noncontrolling interest in a subsidiary is an ownership interest that should be reported as equity in the consolidated financial statements. SFAS 160 establishes a single method of accounting for changes in a parent's ownership interest in a subsidiary that do not result in deconsolidation and requires a parent to recognize a gain or loss in net income when a subsidiary is deconsolidated. SFAS 160 also requires consolidated net income to be reported at amounts that include the amounts attributable to both the parent and the noncontrolling interest and to disclose, on the face of the consolidated statement of income, the amounts of consolidated net income attributable to the parent and to the noncontrolling interest. SFAS 160 is effective for fiscal years beginning on or after December 15, 2008, which for us will be our fiscal year beginning September 1, 2009. The Company is evaluating the impact that SFAS 160 will have on its consolidated financial position and results of operations.

In September 2008, the FASB ratified EITF Issue No. 08-5, "Issuer's Accounting for Liabilities Measured at Fair Value With a Third-Party Credit Enhancement" ("EITF 08-5"). EITF 08-5 provides guidance for measuring liabilities issued with an attached third-party credit enhancement (such as a guarantee). It clarifies that the issuer of a liability with a third-party credit enhancement should not include the effect of the credit enhancement in the fair value measurement of the liability. EITF 08-5 is effective for the first reporting period beginning after December 15, 2008. The Company is currently assessing the impact of EITF 08-5 on its consolidated financial position and results of operations.

Index

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

Overview

Results for the first quarter ended November 30, 2008 reflected a number of challenges including weak consumer sentiment accompanying the general business recession as well as rising commodity and labor costs. System-side same-store sales declined during the quarter, and the performance of Partner Drive-Ins continued to lag behind that of Franchise Drive-Ins. The de-leveraging impact of lower sales volumes coupled with rising costs also led to lower restaurant and operating margins during the quarter.

For the first quarter of fiscal 2009, revenues decreased 3.2%, while operating income decreased 29.7%. Net income decreased 47.5% during the quarter and earnings per share decreased 45.5% to $0.12 per diluted share from $0.22 in the year-earlier period.

The following table provides information regarding the number of Partner Drive-Ins and Franchise Drive-Ins in operation as of the end of the periods indicated as well as the system-wide growth in sales and average unit volume. System-wide information includes both Partner and Franchise Drive-In information, which we believe is useful in analyzing the growth of the brand as well as the Company's revenues since franchisees pay royalties based on a percentage of sales.

System-Wide Performance
($ in thousands)

| | Three months ended November 30, | |
|---|---|---|
| | 2008 | 2007 |
| Percentage increase in sales | 1.2% | 7.2% |
| | | |
| System-wide drive-ins in operation (1): | | |
| Total at beginning of period | 3,475 | 3,343 |
| Opened | 39 | 36 |
| Closed (net of re-openings) | (9) | (11) |
| Total at end of period | 3,505 | 3,368 |
| | | |
| Average sales per drive-in | $ 262 | $ 268 |
| | | |
| Change in same-store sales (2) | (3.6%) | 2.1% |

(1) Drive-ins that are temporarily closed for various reasons (repairs, remodeling, management changes, etc.) are not considered closed unless the Company determines that they are unlikely to reopen within a reasonable time.
(2) Represents percentage change for drive-ins open for a minimum of 15 months.

System-wide same-store sales decreased 3.6% during the first quarter of fiscal year 2009 as a result of decrease in average check and, to a lesser extent, a decrease in traffic (number of transactions per drive-in).

Index

The following table provides information regarding drive-in development across the system. Retrofits represent investments to upgrade the exterior look of our drive-ins, typically including an upgraded building exterior, new more energy-efficient lighting, a significantly enhanced patio area, and improved menu housings.

System-Wide Drive-In Development

| | Three months ended November 30, 2008 | 2007 |
|---|---|---|
| New drive-ins: | | |
| Partner | 5 | 5 |
| Franchise | 34 | 31 |
| System-wide | 39 | 36 |
| Rebuilds/relocations: | | |
| Partner | 2 | – |
| Franchise | 19 | 15 |
| System-wide | 21 | 15 |
| Retrofits, including rebuilds/relocations: | | |
| Partner | 13 | 38 |
| Franchise | 128 | 202 |
| System-wide | 141 | 240 |

Results of Operations

Revenues. The following table sets forth the components of revenue for the reported periods and the relative change between the comparable periods.

Revenues
($ in thousands)

| | Three Months Ended November 30, 2008 | 2007 | Increase/ (Decrease) | Percent Increase/ (Decrease) |
|---|---|---|---|---|
| Revenues: | | | | |
| Partner Drive-In sales | $ 153,047 | $ 159,285 | $ ( 6,238) | (3.9%) |
| Franchise revenues: | | | | |
| Franchise royalties | 29,055 | 28,639 | 416 | 1.5% |
| Franchise fees | 1,171 | 1,240 | (69) | (5.6%) |
| Other | 793 | 1,017 | (224) | (22.0%) |
| Total revenues | $ 184,066 | $ 190,181 | $ ( 6,115) | (3.2%) |

Index

The following table reflects the changes in Partner Drive-In sales, average unit volumes and comparable sales for Partner Drive-Ins. It also presents information about the number of Partner Drive-Ins, which is useful in analyzing the growth of Partner Drive-In sales.

Partner Drive-In Sales
($ in thousands)

| | Three months ended November 30, 2008 | 2007 |
|---|---|---|
| Partner Drive-In sales | $ 153,047 | $ 159,285 |
| Percentage change | (3.9%) | 8.8% |
| | | |
| Drive-ins in operation (1): | | |
| Total at beginning of period | 684 | 654 |
| Opened | 5 | 5 |
| Acquired from (sold to) franchisees | (8) | 5 |
| Closed | (1) | (2) |
| Total at end of period | 680 | 662 |
| | | |
| Average sales per drive-in | $ 226 | $ 243 |
| Percentage change | (7.0%) | 3.3% |
| | | |
| Change in same-store sales (2) | (6.6%) | 2.9% |

(1) Drive-ins that are temporarily closed for various reasons (repairs, remodeling, management changes, etc.) are not considered closed unless the Company determines that they are unlikely to reopen within a reasonable time.
(2) Represents percentage change for drive-ins open for a minimum of 15 months.

For the first fiscal quarter of 2009, Partner Drive-In sales decreased 3.9%. The decrease was largely driven by the decline in same-store sales for existing drive-ins, which was partially offset by sales from newly constructed and acquired drive-ins. The Company believes the decline in performance at Partner Drive-Ins is attributable, at least in part, to consumer reaction to aggressive price increases taken during fiscal year 2007, combined with a decline in service. Since the deterioration in performance became apparent during the third quarter of fiscal year 2008, several actions have been taken, including an organizational restructure (management and personnel changes) as well as a simplified incentive compensation plan, which strengthens the partnership program and places increased emphasis on customer service. In addition, we implemented a more strategic approach to pricing. These efforts are expected to have a positive impact on Partner Drive-In sales.

The following table reflects the growth in franchise income (franchise royalties and franchise fees) as well as franchise sales, average unit volumes and the number of Franchise Drive-Ins. While we do not record Franchise Drive-In sales as revenues, we believe this information is important in understanding our financial performance since these sales are the basis on which we calculate and record franchise royalties. This information is also indicative of the financial health of our franchisees.

Index

Franchise Information
($ in thousands)

| | Three months ended November 30, 2008 | 2007 |
|---|---|---|
| Franchise fees and royalties (1) | $ 30,226 | $ 29,879 |
| Percentage increase | 1.2% | 14.2% |
| | | |
| Franchise Drive-Ins in operation (2): | | |
| Total at beginning of period | 2,791 | 2,689 |
| Opened | 34 | 31 |
| Acquired from (sold to) company | 8 | (5) |
| Closed | (8) | (9) |
| Total at end of period | 2,825 | 2,706 |
| | | |
| Franchise Drive-In sales | $ 757,443 | $ 740,288 |
| Percentage increase | 2.3% | 6.9% |
| | | |
| Effective royalty rate | 3.84% | 3.87% |
| | | |
| Average sales per Franchise Drive-In | $ 270 | $ 274 |
| | | |
| Change in same-store sales (3) | (2.9%) | 1.9% |

(1) See Revenue Recognition Related to Franchise Fees and Royalties in the Critical Accounting Policies and Estimates section of Management's Discussion and Analysis in our Annual Report on Form 10-K for the year ended August 31, 2008.
(2) Drive-ins that are temporarily closed for various reasons (repairs, remodeling, management changes, etc.) are not considered closed unless the Company determines that they are unlikely to reopen within a reasonable time.
(3) Represents percentage change for drive-ins open for a minimum of 15 months.

Franchise royalties experienced a 1.2% increase related primarily to royalties from new Franchise Drive-Ins, offset by the impact of the declining effective royalty rate and the decline in same-store sales at Franchise Drive-Ins.

Franchisee fees remained relatively constant at approximately $1.2 million for the first fiscal quarter of both 2009 and 2008. Franchisees opened 34 new drive-ins in the first fiscal quarter of 2009, compared to 31 new drive-ins in the first fiscal quarter of 2008. Fees associated with the termination of area development agreements decreased $0.2 million for the first fiscal quarter of 2009 compared to prior year, offsetting the higher revenue resulting from the increase in new drive-in openings.

Index

Operating Expenses. The following table presents the overall costs of drive-in operations, as a percentage of Partner Drive-In sales. Minority interest in earnings of Partner Drive-Ins is included as a part of cost of sales, in the table below, since it is directly related to Partner Drive-In operations.

Restaurant-Level Margins

| | Quarter ended November 30, 2008 | Quarter ended November 30, 2007 | Percentage points Increase/ (Decrease) |
|---|---|---|---|
| Costs and expenses: | | | |
| Partner Drive-Ins: | | | |
| Food and packaging | 27.7% | 25.8% | 1.9 |
| Payroll and other employee benefits | 32.6 | 31.0 | 1.6 |
| Minority interest in earnings of Partner Drive-Ins | 2.5 | 3.3 | (0.8) |
| Other operating expenses | 22.6 | 21.0 | 1.6 |
| | 85.4% | 81.1% | 4.3 |

Restaurant-level margins declined overall in the first fiscal quarter of 2009 as a result of higher commodity prices, higher labor costs driven by minimum wage increases and the de-leveraging impact of lower sales. These negative impacts were offset by the decline in minority partners' share of earnings reflecting the margin pressures described above.

Selling, General and Administrative. Selling, general and administrative expenses increased 8.4% to $16.2 million during the first fiscal quarter of 2009 compared to the same period of 2008. Headcount additions were the primary contributor to the year-over-year increase.

Depreciation and Amortization. Depreciation and amortization expense increased 6.7% to $13.0 million in the first quarter. Capital expenditures during the first three months of fiscal year 2009 were $15.1 million. Looking forward, capital expenditures are expected to total approximately $60 to $65 million for the year.

Provision for Impairment of Long-Lived Assets. We assess drive-in assets for impairment on a quarterly basis under the guidelines of SFAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." During the first fiscal quarter of 2009, one Partner Drive-In was impaired, resulting in charges of $0.4 million to reduce the carrying cost of the related assets to estimated fair value. We continue to perform quarterly analyses of certain underperforming drive-ins. It is reasonably possible that the estimate of future cash flows associated with these drive-ins could change in the future resulting in the need to write down assets associated with one or more of these drive-ins to fair value.

Interest Expense. Net interest expense decreased $0.3 million to $11.7 million as compared to the same period in fiscal year 2008. The decrease is primarily attributed to the reduction in debt due to scheduled amortization payments on our fixed rate notes.

Income Taxes. The provision for income taxes reflects an effective federal and state tax rate of 41.4% for the first quarter of fiscal year 2009 as compared to 38.0% in the same period of 2008. The higher rate in the first quarter of fiscal year 2009 is due primarily to federal tax adjustments, the impact of which are amplified by lower net income for the period. Our tax rate may continue to vary significantly from quarter to quarter depending on the timing of stock option exercises and dispositions by stock option-holders and as circumstances on individual tax matters change.

Financial Position

During the first fiscal quarter of 2009, current assets decreased 2.6% to $96.8 million compared to $99.4 million as of the prior fiscal year end, due primarily to lower royalty receivable balances associated with seasonally lower sales and the collection of other receivables.  Net property and equipment decreased approximately $13.3 million primarily as a result of depreciation of $12.9 million and the disposition of $12.5 million in property and equipment related to the sale of eight Partner Drive-Ins to a franchisee, offset by capital expenditures of $15.1 million, and sales and retirement of assets for the balance of the change.  These changes combined with the decrease in current assets to produce a 2.1% decrease in total assets to $818.5 million as of the end of the first quarter of fiscal year 2009.

Index

Total current liabilities decreased $6.7 million or 5.9% during the first fiscal quarter of 2009 primarily as a result of the general decline in payables associated with lower sales.  The noncurrent portion of long-term debt decreased $21.8 million or 3.0% as a result of reflecting scheduled principal payments on the fixed rate notes and payment of $10.0 million on the variable rate notes.  Overall, total liabilities decreased $27.3 million or 3.0% as a result of the items discussed above.

Stockholders' deficit improved $9.4 million or 14.7% during the first three months of fiscal year 2009. Earnings of $7.1 million, along with $2.1 million for the combination of stock compensation and the proceeds and related tax benefits from the exercise of stock options, decreased the stockholders' deficit.

Liquidity and Sources of Capital

Operating Cash Flows.  Net cash provided by operating activities decreased $11.1 million or 37.6% to $18.3 million in the first fiscal quarter of 2009 as compared to $29.4  million in the same period of fiscal year 2008.  The decrease resulted primarily from lower net income for the first fiscal quarter of 2009, along with increased use of cash for operating assets and liabilities.

Investing Cash Flows.  Net cash used in investing activities decreased by $23.2 million to $1.8 million in the first fiscal quarter of 2009 as compared to $25.0 million in the same period of fiscal year 2008.  Capital expenditures of $15.1 million were mostly offset by proceeds of $14.4 million from the sale of Partner Drive-Ins.  We opened five newly constructed Partner Drive-Ins, purchasing the real estate for all of these new drive-ins.  The following table sets forth the components of our investments in capital additions for the first three months of fiscal year 2009 (in millions):

| | | |
|---|---|---|
| New Partner Drive-Ins, including drive-ins under construction | $ | 9.2 |
| Retrofits, drive-thru additions and LED signs in existing drive-ins | | 2.1 |
| Rebuilds, relocations and remodels of existing drive-ins | | 1.0 |
| Replacement equipment for existing drive-ins and other | | 2.8 |
| Total investing cash flows for capital additions | $ | 15.1 |

Financing Cash Flows.  Net cash used in financing activities increased by $13.8 million to $15.0 million in the first fiscal quarter of 2009 as compared to $1.1 million in the same period of fiscal year 2008.  The increase resulted from having sufficient cash on hand to fund operating and investing activities without taking advances on the Variable Funding Notes.  In addition, no purchases of treasury stock were made during the first quarter of fiscal year 2009 compared to $26.7 million the same period of the prior year.

The Company has a securitized financing facility of Variable Funding Notes that provides for the issuance of up to $200.0 million in borrowings and certain other credit instruments, including letters of credit.  As of November 30, 2008, our outstanding balance under the Variable Funding Notes totaled $175.0 million at an effective borrowing rate of 3.38%, as well as $0.3 million in outstanding letters of credit.  Subsequent to November 30, 2008, the Company requested to draw down the remaining $24.7 million available under the Variable Funding Notes.  Two lenders are each responsible for funding 50% of the total amount available.  One of the lenders filed for Chapter 11 bankruptcy on September 15, 2008.  This lender notified the Company that it could not meet its obligation at the current time.  Consequently, of the $24.7 million requested, the Company received approximately $12.4 million.  The Company currently does not consider the remaining amount of approximately $12.3 million to be available.  Prior to August 31, 2008, the Company was aware of possible issues with the lender and had taken advances that were held in cash to ensure liquidity for short-term financing needs.  See Note 9 of the Notes to Consolidated Financial Statements in the Company's Form 10-K for the fiscal year ended August 31, 2008 for additional information regarding our long-term debt.

We plan capital expenditures of approximately $60 to $65 million in fiscal year 2009, excluding potential acquisitions and share repurchases. These capital expenditures primarily relate to the development of additional Partner Drive-Ins, retrofit of existing Partner Drive-Ins and other drive-in level expenditures. We expect to fund these capital expenditures through cash flow from operations as well as cash on hand.

Index

As of November 30, 2008, our total cash balance of $73.7 million ($45.9 million of unrestricted and $27.8 million of restricted cash balances) reflected the impact of the cash generated from operating activities, borrowing activity, and capital expenditures mentioned above. We believe that existing cash and funds generated from operations will meet our needs for the foreseeable future.

Critical Accounting Policies and Estimates

Critical accounting policies are those the Company believes are most important to portraying its financial conditions and results of operations and also require the greatest amount of subjective or complex judgments by management. Judgments and uncertainties regarding the application of these policies may result in materially different amounts being reported under various conditions or using different assumptions. There have been no material changes to the critical accounting policies previously disclosed in the Company's Form 10-K for the fiscal year ended August 31, 2008.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Sonic's use of debt directly exposes the Company to interest rate risk. Floating rate debt, where the interest rate fluctuates periodically, exposes the Company to short-term changes in market interest rates. Fixed rate debt, where the interest rate is fixed over the life of the instrument, exposes the Company to changes in market interest rates reflected in the fair value of the debt and to the risk that the Company may need to refinance maturing debt with new debt at a higher rate. Sonic is also exposed to market risk from changes in commodity prices. Sonic does not utilize financial instruments for trading purposes. Sonic manages its debt portfolio to achieve an overall desired position of fixed and floating rates and may employ interest rate swaps as a tool to achieve that goal in the future.

Interest Rate Risk. Our exposure to interest rate risk at November 30, 2008 is primarily based on the fixed rate notes with an effective rate of 5.7%, before amortization of debt-related costs. At November 30, 2008, the fair value of the fixed rate notes was estimated at $513.2 million versus carrying value of $567.6 million (including accrued interest). Should interest rates and/or credit spreads increase or decrease by one percentage point, the estimated fair value of the fixed rate notes would decrease by approximately $14.5 million or increase by approximately $15.0 million, respectively. The fair value estimate required significant assumptions by management as there are few, if any, securitized loan transactions occuring in the current market. Management used market information available for public debt transactions for companies with ratings that are close to or lower than ratings for the Company (without consideration for the third-party credit enhancement). Management believes this fair value is a reasonable estimate with the information that is available. The difference between fair value and carrying value is attributable to interest rate decreases subsequent to when the debt was originally issued, more than offset by the increase in credit spreads required by issuers of similar debt instruments in the current market.

The variable fundings notes outstanding at November 30, 2008 totaled $175.0 million, with a variable rate of 3.38%. The annual impact on our results of operations of a one-point interest rate change for the balance outstanding would be approximately $1.8 million before tax. In addition, at November 30, 2008, the fair value of the variable funding notes was estimated at $150.3 million versus carrying value of $175.2 million (including accrued interest). Should credit spreads increase or decrease by one percentage point, the estimated fair value of the variable funding notes would decrease by approximately $5.5 million or increase by approximately $5.8 million, respectively. The Company used similar assumptions to value the variable funding notes as were used for the fixed rate notes. The difference between fair value and carrying value is attributable to the increase in credit spreads required by issuers of similar debt instruments in the current market.

For further discussion of our exposure to market risk, refer to Item 7A, Quantitative and Qualitative Disclosures About Market Risk in our Annual Report on Form 10-K for the fiscal year ended August 31, 2008.

16

Item 4. Controls and Procedures

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-14 under the Securities Exchange Act of 1934). Based upon that evaluation, the Chief Executive Officer and the Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective. There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings

The Company is involved in various legal proceedings and has certain unresolved claims pending. Based on the information currently available, management believes that all claims currently pending are either covered by insurance or would not have a material adverse effect on the Company's business or financial condition.

Item 1A. Risk Factors

Except as set forth below, there has been no material change in the risk factors set forth in Part I, Item 1A, Risk Factors in our Annual Report on Form 10-K for the year ended August 31, 2008.

We previously disclosed that Moody's had placed under review for a possible downgrade the credit rating of our third-party insurance company that provides credit enhancements in the form of financial guaranties of our fixed and variable rate note payments. On November 5, 2008, Moody's downgraded the insurer's credit rating to Baa1. We are unable to determine whether further downgrades by Moody's or Standard & Poor's may occur and what impact this downgrade has had or further downgrades would have on our insurer's financial condition. For information regarding the consequences if the insurance company were to become the subject of insolvency or similar proceedings, see Part I, Item IA, Risk Factors in our Annual Report on Form 10-K for the year ended August 31, 2008.

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

(c) Issuer Purchases of Equity Securities

None.

Item 3. Defaults Upon Senior Securities

None.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

| | |
|---|---|
| 31.01 | Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14 |
| 31.02 | Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14 |
| 32.01 | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 |
| 32.02 | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 |

Index

SIGNATURES

Pursuant to the requirements of the Securities Act of 1934, the Company has caused the undersigned, duly authorized, to sign this report on behalf of the Company.

SONIC CORP.

| | | |
|---|---|---|
| Date: January 8, 2009 | By: | /s/ Stephen C. Vaughan<br>Stephen C. Vaughan,<br>Executive Vice President and Chief Financial Officer |

Index

EXHIBIT INDEX

Exhibit Number and Description

31.01 Certification of Chief Executive Officer Pursuant to SEC Rule 13a-14
31.02 Certification of Chief Financial Officer Pursuant to SEC Rule 13a-14
32.01 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350
32.02 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350