



PIZZA PIZZA ROYALTY CORP.

Consolidated Annual Financial Statements
For the years ended December 31, 2020 and 2019



KPMG LLP
100 New Park Place, Suite 1400
Vaughan, ON L4K 0J3
Tel 905-265 5900
Fax 905-265 6390
www.kpmg.ca

INDEPENDENT AUDITORS' REPORT

To the Shareholders of Pizza Pizza Royalty Corp.

Opinion

We have audited the consolidated financial statements of Pizza Pizza Royalty Corp. (the Entity), which comprise:

- the consolidated statements of financial position as at December 31, 2020 and December 31, 2019;
- the consolidated statements of earnings for the years then ended;
- the consolidated statements of comprehensive earnings for the years then ended;
- the consolidated statements of changes in shareholders' equity for the years then ended;
- the consolidated statements of cash flows for the years then ended;
- and notes to the consolidated financial statements, including a summary of significant accounting policies

(Hereinafter referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the consolidated financial position of the Entity as at December 31, 2020 and December 31, 2019, and its consolidated financial performance and its consolidated cash flows for the years then ended in accordance with International Financial Reporting Standards (IFRS).

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the "***Auditors' Responsibilities for the Audit of the Financial Statements***" section of our auditors' report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other ethical responsibilities in accordance with these requirements.



We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements for the year ended December 31, 2020. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

We have determined the matters described below to be the key audit matters to be communicated in our auditors' report.

Evaluation of the impairment assessment for Pizza Pizza and Pizza 73 Rights and Marks

Description of the matter

We draw attention to note 2(j), 2(r(i)), and 3 to the financial statements. The Rights and Marks have an indefinite useful life and are tested annually for impairment or more frequently if there are indications that the asset may be impaired. The Entity has recorded balances of \$272,902 thousand and \$80,814 thousand related to Pizza Pizza and Pizza 73 Right and Marks, respectively, each representing a separate cash-generating unit (CGU). If the estimated recoverable amount of the Rights and Marks is less than their carrying amount, the Rights and Marks are written down to their estimated recoverable amount and an impairment loss is recognized. Determining whether the Rights and Marks are impaired requires an estimation of the recoverable amount of the CGU. The Entity's significant assumptions include expected future cash flows from royalty income, terminal growth rates and discount rates.

Why the matter is a key audit matter

We identified the evaluation of the impairment assessment for Pizza Pizza and Pizza 73 Rights and Marks as a key audit matter. This matter represented an area of significant risk of material misstatement due to the magnitude of the balance and the high degree of estimation uncertainty in determining the recoverable amount. Significant auditor judgment and the involvement of professionals with specialized skills and knowledge was required to evaluate the evidence relating to the Entity's significant assumptions due to the sensitivity of the recoverable amount to minor changes in significant assumptions.

How the matter was addressed in the audit

The primary procedures we performed to address this key audit matter included the following:



We compared the Entity's expected future cash flows from royalty income used in the prior year estimate to actual results to assess the Entity's ability to accurately predict expected future cash flows from royalty income.

We evaluated the appropriateness of the Entity's expected future cash flows from royalty income, by comparing those assumptions to the Entity's historical actual cash flows from royalty income. We took into account changes in conditions and events affecting each CGU to assess the adjustments or lack of adjustments made in arriving at the expected future cash flows from royalty income.

We involved valuation professionals with specialized skills and knowledge, who assisted in:

- Comparing the Entity's terminal growth rates against long term estimates of inflation in Canada
- Comparing the Entity's discount rates against a discount rate range that was independently developed using publicly available market data for comparable entities.

Other Information

Management is responsible for the other information. Other information comprises:

- the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions.

Our opinion on the financial statements does not cover the other information and we do not and will not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, and remain alert for indications that the other information appears to be materially misstated.

We obtained the information included in Management's Discussion and Analysis filed with the relevant Canadian Securities Commissions as at the date of this auditors' report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in the auditors' report.

We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards (IFRS), and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.



In preparing the financial statements, management is responsible for assessing the Entity's ability to continue as a going concern, disclosing as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Entity or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Auditors' Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.

The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast



significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.
- Provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.
- Determine, from the matters communicated with those charged with governance, those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditors' report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our auditors' report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

The engagement partner on the audit resulting in this auditors' report is Elliot Marer

Vaughan, Canada

March 2, 2021

Pizza Pizza Royalty Corp.

Consolidated Statements of Financial Position

As at December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars)

| | December 31, 2020 \$ | December 31, 2019 \$ |
|---|----------------------------|----------------------------|
| Assets | | |
| Current assets | | |
| Cash | 2,250 | 535 |
| Short-term investments | 2,750 | 2,750 |
| Receivable from Pizza Pizza Limited (note 10) | 2,753 | 3,304 |
| Trade and other receivables | 76 | 91 |
| Total current assets | 7,829 | 6,680 |
| Non-current assets | | |
| Pizza Pizza Rights and Marks (note 3) | 272,902 | 271,586 |
| Pizza 73 Rights and Marks (note 3) | 80,814 | 80,232 |
| Derivative financial instruments (note 12) | - | 510 |
| Total non-current assets | 353,716 | 352,328 |
| Total assets | 361,545 | 359,008 |
| Liabilities and shareholders' equity | | |
| Current liabilities | | |
| Trade and other payables (note 4) | 417 | 481 |
| Payable to Pizza Pizza Limited (note 10) | 644 | 694 |
| Dividends payable to shareholders | 1,354 | 1,755 |
| Income taxes payable | 26 | 167 |
| Total current liabilities | 2,441 | 3,097 |
| Non-current liabilities | | |
| Borrowings (note 5) | 46,924 | 46,909 |
| Deferred tax liability | 21,641 | 21,543 |
| Derivative financial instruments (note 12) | 2,138 | - |
| Total non-current liabilities | 70,703 | 68,452 |
| Shareholders' equity | | |
| Share capital | 242,030 | 242,030 |
| Exchangeable Shares (note 6) | 82,847 | 80,949 |
| Accumulated other comprehensive earnings | (1,695) | 664 |
| Deficit | (34,781) | (36,184) |
| Total shareholders' equity | 288,401 | 287,459 |
| Total liabilities and shareholders' equity | 361,545 | 359,008 |

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Earnings

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Royalty income (note 9) | 31,789 | 35,946 |
| Administrative expenses | (636) | (494) |
| Operating earnings | 31,153 | 35,452 |
| Interest expense on borrowings (note 5) | (1,222) | (1,335) |
| Swap expiry (note 12) | 502 | - |
| Earnings for the period before income taxes | 30,433 | 34,117 |
| Current tax expense | (5,069) | (5,891) |
| Deferred tax expense | (890) | (921) |
| Earnings for the period attributable to shareholders | 24,474 | 27,305 |
| Weighted average number of shares – basic and diluted (note 8) | 32,177,276 | 31,967,706 |
| Basic and diluted earnings per share (note 8) | 0.76 | 0.85 |

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Comprehensive Earnings

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars)

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Earnings for the period | 24,474 | 27,305 |
| Other comprehensive earnings (loss) | | |
| Items reclassified to net earnings: | | |
| Cash flow hedges (note 12) | (502) | - |
| Deferred tax impact of cash flow hedges | 255 | - |
| Items that may be reclassified subsequently to net earnings: | | |
| Cash flow hedges | (2,648) | 371 |
| Deferred tax impact of cash flow hedges | 536 | (78) |
| Total comprehensive earnings | 22,115 | 27,598 |

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Changes in Shareholders' Equity

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars)

| | Share capital \$ | Exchangeable Shares \$ | Accumulated other comprehensive earnings (loss) \$ | Deficit \$ | Total shareholders' equity \$ |
|--|---------------------|------------------------------|---|-----------------|--|
| At December 31, 2019 | 242,030 | 80,949 | 664 | (36,184) | 287,459 |
| Comprehensive earnings | | | | | |
| Earnings for the period | - | - | - | 24,474 | 24,474 |
| Cash flow hedges | - | - | (3,150) | - | (3,150) |
| Deferred tax impact of cash flow hedges | - | - | 791 | - | 791 |
| Total comprehensive earnings (loss) | - | - | (2,359) | 24,474 | 22,115 |
| Transactions with shareholders | | | | | |
| Exchangeable Shares (note 6) | - | 1,898 | - | - | 1,898 |
| Dividends declared to shareholders | - | - | - | (16,590) | (16,590) |
| Distributions on Class B and Class D Exchangeable Shares | - | - | - | (6,481) | (6,481) |
| Total transactions with shareholders | - | 1,898 | - | (23,071) | (21,173) |
| At December 31, 2020 | 242,030 | 82,847 | (1,695) | (34,781) | 288,401 |
| At December 31, 2018 | 242,030 | 77,547 | 371 | (34,655) | 285,293 |
| Comprehensive earnings | | | | | |
| Earnings for the period | - | - | - | 27,305 | 27,305 |
| Cash flow hedges | - | - | 371 | - | 371 |
| Deferred tax impact of cash flow hedges | - | - | (78) | - | (78) |
| Total comprehensive earnings | - | - | 293 | 27,305 | 27,598 |
| Transactions with shareholders | | | | | |
| Exchangeable Shares (note 6) | - | 3,402 | - | - | 3,402 |
| Dividends declared to shareholders | - | - | - | (21,063) | (21,063) |
| Distributions on Class B and Class D Exchangeable Shares | - | - | - | (7,771) | (7,771) |
| Total transactions with shareholders | - | 3,402 | - | (28,834) | (25,432) |
| At December 31, 2019 | 242,030 | 80,949 | 664 | (36,184) | 287,459 |

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Consolidated Statements of Cash Flows

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars)

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Cash provided by (used in) | | |
| Operating activities | | |
| Earnings for the period | 24,474 | 27,305 |
| Amortization of deferred financing fees | 15 | 5 |
| Non-cash swap expiry (note 12) | (502) | - |
| Off-market swap payments | - | 63 |
| Deferred tax expense | 890 | 921 |
| Changes in non-cash working capital (note 11) | 311 | 3 |
| Cash provided by operating activities | 25,188 | 28,297 |
| Financing activities | | |
| Debt refinancing fees | - | (38) |
| Dividends paid to shareholders | (16,992) | (21,063) |
| Distributions on Class B and Class D Exchangeable Shares | (6,481) | (7,771) |
| Cash used in financing activities | (23,473) | (28,922) |
| Investing activities | | |
| Proceeds on redemption of short-term investment | 500 | - |
| Investment in short-term investment | (500) | - |
| Cash provided by investing activities | - | - |
| Increase (Decrease) in cash | 1,715 | (625) |
| Cash, beginning of period | 535 | 1,160 |
| Cash, end of period | 2,250 | 535 |
| Supplementary information | | |
| Interest paid | 1,207 | 1,266 |
| Income taxes paid | 5,210 | 5,760 |
| Total cash and short-term investments | | |
| Cash | 2,250 | 535 |
| Short-term investments | 2,750 | 2,750 |
| Total cash and short-term investments | 5,000 | 3,285 |

The accompanying notes are an integral part of these consolidated financial statements.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

1. General information

The Pizza Pizza Royalty Corp. (the “Company”) is governed by the *Business Corporations Act* (Ontario) pursuant to its articles of incorporation dated April 4, 2012 and articles of arrangement dated December 31, 2012. The Company’s common shares are traded on the Toronto Stock Exchange under the stock symbol PZA. The Company is incorporated and domiciled in Canada, and the address of its registered office is 500 Kipling Avenue, Toronto, Ontario, Canada.

The Company acquired, through the Pizza Pizza Royalty Limited Partnership (the “Partnership”), the trademarks, trade names, operating procedures, systems and other intellectual property and proprietary rights associated therewith owned by Pizza Pizza Limited (“PPL”) used in connection with the operation of all restaurants operated by PPL, its subsidiaries and its franchisees (collectively, the “Pizza Pizza Rights and Marks”).

Concurrent with the acquisition of the Pizza Pizza Rights and Marks on July 6, 2005, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza Pizza Rights and Marks for an initial term of 99 years for which PPL pays a royalty equal to 6% of system sales from all Pizza Pizza restaurants in the Royalty Pool, as defined in the Pizza Pizza Licence and Royalty Agreement.

On July 24, 2007, the Company, through the Partnership, acquired the trademarks, trade names, operating procedures and systems, and other intellectual property and proprietary rights owned by Pizza 73 Inc. and its affiliated companies (together, “Pizza 73”) used in connection with the operation of all restaurants operated by Pizza 73 and its partners (collectively, the “Pizza 73 Rights and Marks”).

Concurrent with the acquisition of the Pizza 73 Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza 73 Rights and Marks for an initial term of 99 years for which PPL pays a royalty equal to 9% of system sales from all Pizza 73 restaurants in the Royalty Pool, as defined in the Pizza 73 Licence and Royalty Agreement.

As at December 31, 2020, there were 645 Pizza Pizza restaurants and 104 Pizza 73 restaurants in the Royalty Pool (2019 – 660 and 112, respectively); the Royalty Pool is adjusted annually on January 1.

The Company pays monthly dividends directly to public shareholders. For the year ended December 31, 2020, the Company declared dividends of \$0.6739 per share (2019 – \$0.8556 per share).

PPL, a privately owned corporation headquartered in Toronto, Ontario, operates in the food service industry primarily throughout Ontario and Alberta, and primarily franchises and operates quick-service restaurant businesses under the Pizza Pizza and Pizza 73 brands. PPL derives revenue from franchisees through the sale of franchise restaurants, food and supplies and royalties. PPL also derives revenue from company owned and jointly controlled restaurants through the sale of food products to retail customers. The Company’s revenue is earned from certain operations of PPL and, accordingly, the revenue of the Company and its ability to pay dividends to shareholders are dependent on the ability of PPL to generate and pay royalties to the Company.

2. Significant accounting policies

The significant accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all periods presented unless otherwise stated.

a. Statement of compliance

The Company prepares its consolidated financial statements in accordance with International Financial Reporting Standards (“IFRS”) as issued by the International Accounting Standard Board (“IASB”). The policies applied in these consolidated financial statements are based on IFRS standards, which have been applied

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

consistently to all periods presented. These consolidated financial statements were issued and effective as at March 2, 2021, the date the Board of Directors approved the consolidated financial statements.

b. Basis of measurement

The consolidated financial statements have been prepared under the historical cost convention, except for the revaluation of the interest rate swap to fair value through the consolidated statement of comprehensive income.

c. Consolidation

The consolidated financial statements incorporate the assets and liabilities of the Company and its subsidiaries as at December 31, 2020 and 2019 and the results of these subsidiaries for the years then ended. The Company's subsidiaries and its respective holdings at December 31, 2020 and 2019 are outlined below:

| Subsidiary | December 31, 2020 | December 31, 2019 |
|---|--------------------------|--------------------------|
| Pizza Pizza GP Inc. | 76.5% | 77.0% |
| Pizza Pizza Royalty Limited Partnership | 76.5% | 77.0% |

An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. Furthermore, an investor controls an investee if and only if the investor has all the following: power over the investee; exposure, or rights to variable returns from its involvement with the investee and the ability to use its power over the investee to affect the amount of the investor's returns.

Subsidiaries are fully consolidated from the date on which control is transferred to the Company and de-consolidated from the date that control ceases. Inter-entity transactions, balances and unrealized gains/losses on transactions between entities are eliminated. There are no unconsolidated structured entities.

d. Financial assets and liabilities

Financial assets and liabilities are recognized when the Company becomes a party to the contractual provisions of the instrument. Financial assets and liabilities are derecognized when the rights to receive or obligation to pay cash flows from the assets or liabilities have expired or been settled or have been transferred and the Company has transferred substantially all risks and rewards of ownership. After initial recognition, financial assets are measured at their fair value, except for those measured at amortized cost. After initial recognition, financial liabilities are measured at amortized cost except for financial liabilities at fair value through profit or loss which are measured at fair value.

The Company classifies its financial instruments in the following categories:

- a) Financial assets and liabilities at amortized cost. The Company classifies its financial assets at amortized cost only if both of the following criteria are met:
 - i) the asset is held within a business model whose objective is to collect the contractual cash flows; and
 - ii) the contractual terms give rise to cash flows that are solely payments of principal and interest.

The Company's financial assets at amortized cost are comprised of cash, short-term investments, receivable from Pizza Pizza Limited, and trade and other receivables. These are included in current assets due to their short-term nature. Financial assets at amortized cost are initially recognized at the amount expected to be received less, when material, a discount to reduce the assets to fair value. Subsequently, financial assets at

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

amortized cost are measured at amortized cost using the effective interest method less a provision for impairment.

Financial liabilities at amortized cost include trade and other payables, dividends payable to shareholders, payable to Pizza Pizza Limited, income tax payable and the credit facility. Trade and other payables are initially recognized at the amount required to be paid less, when material, a discount to reduce payables to fair value. Subsequently, trade and other payables are measured at amortized cost using the effective interest method. Dividends payable to shareholders are recognized at the amount required to be paid. The credit facility is recognized initially at fair value, net of any transaction costs incurred, and subsequently at amortized cost using the effective interest method. Financial liabilities are classified as current liabilities if payment is due within 12 months. Otherwise, they are presented as non-current liabilities.

- b) Financial assets at fair value through other comprehensive income (FVOCI): Financial assets at FVOCI comprise:
- i) equity securities which are not held for trading and which the Company has irrevocably elected at initial recognition to recognize in this category; and
 - ii) debt securities where the contractual cash flows are solely principal and interest and the objective of the Company's business model is achieved both by collecting contractual cash flows and selling financial assets.

The Company's financial assets classified as FVOCI include derivative financial instruments. The Company utilizes derivative financial instruments in the normal course of its operations as a means to manage risks from fluctuations in interest rates. The Company's policy is not to utilize derivative financial instruments for trading or speculative purposes. The Company's derivatives are interest rate swaps with changes in fair value recorded in the consolidated statement of comprehensive income.

- c) Financial assets at fair value through profit or loss (FVPL): The Company classifies the following financial assets at FVPL:
- i) debt instruments that do not qualify for measurement at either amortized cost or FVOCI;
 - ii) equity instruments that are held for trading; and
 - iii) equity instruments for which the Company has not elected to recognize fair value gains and losses through other comprehensive income.

The Company has not classified any of its financial instruments as FVPL.

e. Impairment of financial assets

IFRS 9 requires the Company to record an allowance for expected credit losses (ECLs) for all debt financial instruments held at amortized cost or fair value through other comprehensive income.

ECLs are based on the difference between the contractual cash flows due in accordance with the contract and all the cash flows that the Company expects to receive. The shortfall is then discounted at an approximation to the asset's original effective interest rate.

The Company has established a provision matrix that is based on the Company's historical credit loss experience, adjusted for forward-looking factors specific to the debtors and the economic environment.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

f. Derivative financial instruments and hedging activities

Derivative financial instruments include interest rate swaps and are initially measured at fair value on the date the derivative contract is entered into and are subsequently re-measured at each reporting date at their fair value. The Company designates its interest rate swaps as cash flow hedges.

The Company documents, at the inception of the transaction, the relationship between the hedging instrument and the hedged item, as well as its risk management objectives and strategy for undertaking the hedging transaction. The Company also documents its assessment, both at inception and at each reporting date, of whether the derivative that is used has been highly effective in offsetting cash flows of hedged items.

The changes in fair value of the interest rate swaps are included in other comprehensive earnings to the extent the hedge continues to be highly effective. The related other comprehensive earnings (loss) amounts are allocated to the consolidated statements of earnings in the same period in which the hedged item affects earnings. To the extent the change in fair value of the derivative financial instruments is not completely offset by the change in the fair value of the hedged item, the ineffective portion of the hedging relationship is recorded immediately in the consolidated statements of earnings.

The fair value of the interest rate swaps is estimated based on the standard swap valuation methodology; that is, the value of the swap is calculated as the difference between the present values of the future cash flows associated with the floating-receive leg and the fixed-pay leg.

g. Short-term investments

The short-term investments include amounts invested in Guaranteed Investment Certificates with maturities at acquisition between 90 and 365 days.

h. Trade and other receivables

Trade and other receivables are initially recognized at fair value and subsequently measured at amortized cost using the effective interest method, less any provision for impairment. If collection is expected in one year or less, they are classified as current assets. If not, they are presented as non-current assets.

i. Pizza Pizza and Pizza 73 Rights and Marks

Rights and Marks that have an indefinite life are recorded at cost and are not being amortized. Management considers the Pizza Pizza and Pizza 73 Rights and Marks to be indefinite-life assets. Indefinite-life intangible assets principally comprise those trademarks for which there is no foreseeable limit to the period over which they are expected to generate net cash inflows. Rights and Marks are considered to have an indefinite life given the strength and durability of the brands and the level of marketing support. Brands that are classified as indefinite have been in the market for many years, and the nature of the industry PPL operates in is such that brand obsolescence is not common if appropriately supported by advertising and marketing spending.

A description of each of the Rights and Marks is as follows:

Pizza Pizza Rights and Marks

The Rights and Marks include the Pizza Pizza Marks and any value associated with the copyrights, the trade names, trade secrets, methods, systems and procedures for the construction, design or operation of Pizza Pizza restaurants using certain types of equipment, supplies, ingredients, recipes, merchandising, advertising and business techniques, together with the rights to order phone numbers and order website domain names that are currently owned by PPL and used in connection with the operation of Pizza Pizza restaurants.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The Marks include all trademarks that are registered or the subject of pending applications for registration under the Trade-marks Act (Canada) and other unregistered trademarks used in connection with the Pizza Pizza restaurant businesses.

Pizza 73 Rights and Marks

The Rights and Marks include all intellectual property rights, whether registered or not, including the Pizza 73 Marks and all goodwill associated therewith, all know-how and related technical knowledge and all other proprietary rights pertaining to or used in connection with the Pizza 73 business, including all copyrights, trade names, business names, trade secrets, confidential information, uniform standards, methods, systems and procedures for establishment, construction, design, operation or marketing of Pizza 73 Restaurants using certain types of equipment, supplies, ingredients, recipes, merchandising, advertising and business techniques, together with the rights to order phone numbers and order website domain names that are currently owned by PPL and used in connection with the operation of Pizza 73 Restaurants, and all copyrights in the operations manuals and similar manuals or documents, as amended from time to time, as well as all copyrights in all menus and advertising and promotional materials.

The Marks include all trademarks that are registered or the subject of pending applications for registration under the Trade-marks Act (Canada) and other unregistered trademarks, trade dress, distinguishing guises, logos, slogans, brand names, domain names, commercial symbols and other indicia of origin used in connection with the Pizza 73 business.

j. Impairment of Rights and Marks

The Rights and Marks have an indefinite useful life, are not subject to amortization and are tested annually for impairment or more frequently if there are indications that the asset may be impaired. If the estimated recoverable amount of the Rights and Marks is less than their carrying amount, the Rights and Marks are written down to their estimated recoverable amount and an impairment loss is recognized in the consolidated statements of earnings. The recoverable amount of the Rights and Marks is the higher of their fair value less costs to sell and value in use. For the purposes of assessing impairment, assets are grouped at the lowest levels for which there are separately identifiable cash inflows (cash-generating units or CGUs). There are two CGUs: Pizza Pizza restaurants and Pizza 73 restaurants.

Rights and Marks on which an impairment had previously been recorded are reviewed for possible reversal of the impairment at each reporting date.

k. Trade and other payables

Trade and other payables are obligations to pay for goods or services that have been acquired in the ordinary course of business from suppliers. Trade and other payables are classified as current liabilities if payment is due within one year or less.

l. Borrowings

Borrowings are initially recognized at fair value net of any financing fees. Borrowings are classified as current liabilities unless the Company has an unconditional right to defer settlement of the liability for more than 12 months. After initial recognition, borrowings are carried at amortized cost with any difference between the proceeds (net of financing fees) and the redemption value recognized in the consolidated statements of earnings over the period of the borrowing, using the effective interest method.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

m. Exchangeable Shares

The Class B Units and Class D Units of the Partnership are economically equivalent to, and exchangeable into the common shares of the Company ("Exchangeable Shares"). Therefore, Exchangeable Shares have been presented as part of equity as though they have been converted. Earnings of the Partnership are attributable to PPL and the Company, based on their proportional interest.

n. Income taxes

Income tax expense for the year is comprised of current and deferred tax. Income tax is recognized in the consolidated statements of earnings except to the extent it relates to items recognized in other comprehensive earnings or directly in equity. Taxable income earned by the Partnership is allocated to PPL and the Company, based on their proportional interest. Income tax expense recorded in the consolidated statements represents the taxes on income allocated to the Company.

Current income tax

Current income tax expense is based on the profit for the year as adjusted for items that are not taxable or not deductible. Current tax is calculated using tax rates and laws that were substantively enacted at the end of the reporting year. Management periodically evaluates positions taken in tax returns with respect to situations in which applicable tax regulation is subject to interpretation and establishes provisions where appropriate on the basis of amounts expected to be paid to the tax authorities.

Deferred tax

Deferred tax is recognized on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements.

Deferred tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the consolidated balance sheet dates and are expected to apply when the related deferred tax asset is realized or the deferred tax liability is settled. The measurement of deferred tax assets and liabilities reflect the tax consequences that would follow from the manner in which the Company expects, at the end of the reporting period, to recover or settle the carrying amounts of its assets and liabilities.

Deferred tax assets are recognized only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilized.

Deferred tax assets and liabilities are offset when there is a legally enforceable right to offset, and when the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority where there is an intention to settle the balances on a net basis.

o. Revenue recognition

The Company collects royalty income from PPL based on system sales of Pizza Pizza and Pizza 73 restaurants. Royalty income is recognized on an accrual basis equal to 6% of system sales from all Pizza Pizza restaurants in the Royalty Pool and 9% of system sales from all Pizza 73 restaurants in the Royalty Pool, as allowed under the exception relating to recognition of sales or usage based royalties from licences of intellectual property.

Interest income is recognized using the effective interest rate method.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

p. Dividends to shareholders

The amount of dividends is determined with reference to distributable cash, which is calculated as earnings for the year adjusted for non-cash charges less payment of interest on the borrowings and current income tax expense. Dividends to shareholders are recorded when declared, and paid monthly.

q. Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the chief operating decision-maker. The Board of Directors is the chief operating decision-maker, which is responsible for allocating resources and assessing performance of the operating segment. The Company has determined that it has one operating segment being the receipt of royalty income from the ownership of the Pizza Pizza and Pizza 73 Rights and Marks.

r. Critical accounting estimates and assumptions

The Company makes estimates and assumptions concerning the future. The resulting accounting estimates will, by definition, seldom equal the related actual results. Significant estimates and judgements made by management in the application of IFRS that have a significant effect on the amounts recognized in these consolidated financial statements are as follows:

i. Impairment of Rights and Marks

Determining whether the Rights and Marks are impaired requires an estimation of the recoverable amount of the CGU in which the assets are included. The value-in-use calculation requires that the Company estimate the expected future cash flows from royalty income, terminal growth rates and discount rates. The significant assumptions used in the impairment tests performed at December 31, 2020 and December 31, 2019 are disclosed in note 3.

ii. Consolidation

Determining whether the Partnership is consolidated by the Company or PPL requires judgment. The significant judgments that were used to apply IFRS 10 included assessing which party had the power or current ability to direct decisions over the value creation and maintenance of the Pizza Pizza Rights and Marks and Pizza 73 Rights and Marks in the context of the purpose and design of the Partnership. Based on an assessment of the activities of the Partnership, it was concluded that the Company controls the Partnership and therefore consolidates its operations.

iii. Fair value of derivatives

The fair value of the interest rate swaps that are not traded in an active market is determined using valuation techniques. The Company uses its judgment to select a method and makes assumptions that are mainly based on market conditions existing at the end of each reporting period.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

3. Pizza Pizza and Pizza 73 Rights and Marks

| | Pizza Pizza Rights and Marks \$ | Pizza 73 Rights and Marks \$ | Total \$ |
|--|--|---------------------------------------|----------------|
| Net book value at December 31, 2018 | 270,225 | 78,191 | 348,416 |
| Accretion of value – January 1, 2019 vend-in | 1,361 | 479 | 1,840 |
| Accretion of value – January 1, 2018 true-up | - | 1,562 | 1,562 |
| Net book value at December 31, 2019 | 271,586 | 80,232 | 351,818 |
| Accretion of value – January 1, 2020 vend-in | 15 | - | 15 |
| Accretion of value – January 1, 2019 true-up | 1,301 | 582 | 1,883 |
| Net book value at December 31, 2020 | 272,902 | 80,814 | 353,716 |

The Company, through its interest in the Partnership, acquired the Pizza Pizza Rights and Marks used in the Pizza Pizza quick service restaurant business in Canada in July 2005. Funding for the purchase came from the completion of the Pizza Pizza Royalty Income Fund's initial public offering in July 2005 and from proceeds of the term loan. Concurrent with the acquisition of the Pizza Pizza Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza Pizza Rights and Marks for an initial term of 99 years, for which PPL pays a royalty equal to 6% of system sales for all Pizza Pizza restaurants in the Royalty Pool, as defined in the Pizza Pizza Licence and Royalty Agreement.

In July 2007, the Company, through its interest in the Partnership, acquired the Pizza 73 Rights and Marks from Pizza 73. The purchase was funded by a public and private placement of Fund units and proceeds from the term loan. Concurrent with the acquisition of the Pizza 73 Rights and Marks, the Partnership granted PPL an exclusive and unlimited licence to use the Pizza 73 Rights and Marks for an initial term of 99 years, for which PPL pays a royalty equal to 9% of system sales of all Pizza 73 restaurants included in the Royalty Pool, as defined in the Pizza 73 Licence and Royalty Agreement.

Annually, on January 1 (the "Adjustment Date"), the Royalty Pool is adjusted to include the forecasted system sales from new Pizza Pizza restaurants opened on or before December 31 of the prior year, less system sales from any Pizza Pizza restaurants that have been permanently closed during the year. Similarly, on the Adjustment Date, the Royalty Pool is adjusted to include the forecasted system sales from new Pizza 73 restaurants opened on or before September 1 of the prior year, less any Pizza 73 restaurants permanently closed during the calendar year. In return for adding net additional royalty revenue, PPL receives the right to indirectly acquire additional shares of the Company through an adjustment to the Class B and Class D Exchange Multiplier (see note 6).

As a result of adding new restaurants to the Royalty Pool on January 1, 2020, the Rights and Marks increased by \$15 in 2020 (2019 – \$1,840) and increased by \$1,883 related to the January 1, 2019 true-up (2019 – \$1,562).

Impairment test on the Rights and Marks

The Company performed impairment tests for both the Pizza Pizza and Pizza 73 Rights and Marks at December 31, 2020 and 2019 in accordance with the accounting policy as described in note 2. The recoverable amount of each CGU was determined based on value-in-use calculations. These calculations used expected future cash flows from royalty income based on financial budgets approved by the Board of Directors covering a one-year period and extrapolated for three years. Cash flows beyond the four-year period are estimated using a terminal growth rate as stated below.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The key assumptions used for the value-in-use calculation as at December 31, 2020 were as follows:

| | Terminal Growth rate | Pre-tax discount rate |
|-----------------|----------------------|-----------------------|
| Pizza Pizza CGU | 2.5% | 8.0% |
| Pizza 73 CGU | 2.5% | 8.0% |

The key assumptions used for the value-in-use calculation as at December 31, 2019 were as follows:

| | Terminal Growth rate | Pre-tax discount rate |
|-----------------|----------------------|-----------------------|
| Pizza Pizza CGU | 2.5% | 9.6% |
| Pizza 73 CGU | 2.5% | 9.6% |

The impairment tests performed resulted in no impairment of the Rights and Marks as at December 31, 2020 (2019 – nil).

4. Trade and other payables

| | December 31, 2020 | December 31, 2019 |
|---------------------------------------|----------------------|----------------------|
| | \$ | \$ |
| Accruals | 134 | 134 |
| Other payables | 283 | 347 |
| Total trade and other payables | 417 | 481 |

5. Borrowings

| | December 31, 2020 | December 31, 2019 |
|---|----------------------|----------------------|
| | \$ | \$ |
| Borrowings | 47,000 | 47,000 |
| Less: unamortized deferred financing fees | 76 | 91 |
| Total borrowings | 46,924 | 46,909 |

The borrowings are a committed, non-revolving, five-year facility maturing on April 24, 2025, and were used to finance a portion of the acquisition costs of the Pizza Pizza Rights and Marks in 2005 and the Pizza 73 Rights and Marks in 2007. As security for repayment of the facility, PPL grants a continuing general security interest subject to certain exceptions, in all present and acquired property of PPL, which may not be assigned without the prior consent of PPL and the bank.

On June 28, 2019, the Partnership amended and extended its \$47 million credit facility with a syndicate of chartered banks from April 2020 to April 2025. The facility bears interest at a fixed Bankers' Acceptance rate plus 0.875% to 1.375%, depending on the level of certain covenant calculations. The effective rate is comprised of a portion fixed with two interest rate swaps at 1.875% plus the credit spread, currently set at 0.875%. In the third quarter of 2019, the Partnership entered into a five year forward swap arrangement, which commenced April 2020. The credit facility has a new, effective interest rate of 2.685% comprised of a fixed rate of 1.81% plus a credit spread, currently at 0.875%, as of December 31, 2020.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

Interest expense incurred and paid on borrowings are as follows:

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Interest expense | 1,207 | 1,330 |
| Loan fee amortization | 15 | 5 |
| Interest expense incurred on borrowings | 1,222 | 1,335 |
| Interest paid to (Interest received from) draw down swap termination and out-of-market costs | - | (64) |
| Interest paid on borrowings and loan fee amortization | 1,222 | 1,271 |

Principal repayments on borrowings of \$47,000 are due on April 24, 2025.

The facility is subject to certain financial covenants, all of which have been met as at December 31, 2020. The borrowings are held within the Partnership, and therefore, the financial covenants for the borrowings pertain only to the results of the Partnership and not the Company.

6. Exchangeable Shares

As at December 31, 2020, PPL indirectly holds an effective 23.5% interest in the Company (December 31, 2019 – 23.0%) by holding all Class B and Class D Units of the Partnership. Subject to the Amended and Restated Exchange Agreement (“Exchange Agreement”), PPL has the right to exchange one Class B or Class D Unit indirectly for that number of shares equal to the Class B Exchange Multiplier or Class D Exchange Multiplier, respectively, applicable at the date of such exchange, as described under “Licence and Royalty Adjustment of the Royalty Pool Changes in the Restaurants in the Royalty Pool” in the Exchange Agreement.

Subject to the prior rights of the Company’s Class C Units, a monthly distribution is paid to both PPL (as holders of the Class B and Class D Units) and the Company (as holders of the Class A Units), on a pro rata ownership basis. Distributions are subject to the discretion of the Pizza Pizza GP Inc., which the Company controls. Distributions made to PPL are recorded directly in equity. The equivalent number of Class B and Class D Exchangeable Shares outstanding are as follows:

| | Number of Class B Exchangeable Shares | Number of Class D Exchangeable Shares | Total Number of Exchangeable Shares | Amount \$ |
|------------------------------|--|--|---|---------------|
| At December 31, 2018 | 5,018,210 | 2,029,401 | 7,047,611 | 77,547 |
| Add: January 1, 2019 vend-in | 150,398 | 52,925 | 203,323 | 1,840 |
| Add: January 1, 2018 true-up | - | 98,380 | 98,380 | 1,562 |
| At December 31, 2019 | 5,168,608 | 2,180,706 | 7,349,314 | 80,949 |
| Add: January 1, 2020 vend-in | 1,536 | - | 1,536 | 15 |
| Add: January 1, 2019 true-up | 143,765 | 64,269 | 208,034 | 1,883 |
| At December 31, 2020 | 5,313,909 | 2,244,975 | 7,558,884 | 82,847 |

a. 2019 Royalty Pool Adjustment

In early January 2020 a second adjustment was made to the royalty payments and PPL’s Class B Exchange Multiplier based on the actual performance of the 18 new restaurants added to the Royalty Pool on January 1, 2019. As a result of the adjustments, the Class B Exchange Multiplier is 2.117969 and Class B Units can be exchanged for 5,312,373 shares effective January 1, 2019.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

In early January 2020, a second adjustment was made to the royalty payments and PPL's Class D Exchange Multiplier based on the actual performance of the seven Pizza 73 restaurants added to the Royalty Pool on January 1, 2019. As a result of the adjustments, the Class D Exchange Multiplier is 22.44976 and Class D Units can be exchanged for 2,244,975 shares effective January 1, 2019.

b. 2020 Royalty Pool Adjustment – Class B Exchange Multiplier

On January 1, 2020, 15 net Pizza Pizza restaurants were removed from the Royalty Pool as a result of 19 new restaurants opening and 34 closing from January 1, 2019 to December 31, 2019. The total number of Pizza Pizza restaurants in the Royalty Pool has decreased to 645. The additional system sales from the 19 new restaurants are estimated at \$8,725 annually, less sales of \$8,687 from 34 permanently closed Pizza Pizza restaurants, resulting in net estimated Pizza Pizza sales of \$38 added to the Royalty Pool. The yield of the shares was determined to be 9.0% calculated using \$9.54 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2020. As a result of the contribution of the additional net sales to the Royalty Pool, the Class B Exchange Multiplier increased fractionally by 80% of the total adjustment or 0.000612; the new Class B Multiplier is 2.118582. This adjustment will also increase the entitlement of the holders of the Class B units to distributions of cash and allocations of income from the Partnership. The second adjustment to the Class B Exchange Multiplier will be adjusted to be effective January 1, 2020, once the actual performance of the new restaurants is determined in early 2021. See subsequent events – note 13.

c. 2020 Royalty Pool Adjustment – Class D Exchange Multiplier

On January 1, 2020, eight net Pizza 73 restaurants were removed from the Royalty Pool as a result of one new restaurant opening between September 2, 2018 and September 1, 2019 and nine restaurants closing between January 1, 2019 and December 31, 2019. The forecasted additional system sales from the one new restaurant is estimated at \$546 annually, less \$1,186 in system sales attributable to the nine closed Pizza 73 restaurants. As a result, a negative \$640 net, estimated Pizza 73 sales were removed from the Royalty Pool. The net estimated sales were further reduced by \$1,446 in system sales attributable to certain restaurants previously added to the Royalty Pool whose territory adjusted a previously existing restaurant. The total number of Pizza 73 restaurants in the Royalty Pool has decreased to 104.

Since the system sales of the closed Pizza 73 restaurants exceeded the additional system sales of the additional restaurant added to the Pizza 73 Royalty Pool, the Make-Whole Payment paid by PPL to the Partnership will be carried over, and continue to be paid for subsequent years, until on an Adjustment Date, additional system sales of additional restaurants are sufficient to offset the Pizza 73 system sales attributable to all closed Pizza 73 restaurants.

The yield of the shares was determined to be 9.0% calculated using \$9.54 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2020. As per the Pizza Pizza Royalty Limited Partnership agreement, whenever the Estimated Determined Amount is negative it shall be deemed to be zero. Accordingly, the Class D Exchange Multiplier remained unchanged at 22.44976. The second adjustment to the Class D Exchange Multiplier will be adjusted to be effective January 1, 2020, once the actual performance of the new restaurant is determined in early 2021. See subsequent events – note 13.

d. Pizza Pizza Royalty Corp. Outstanding Shares

In exchange for adding the forecasted Pizza Pizza system sales to the Royalty Pool, PPL has received 1,536 additional equivalent Shares (through the change to the Class B Exchange Multiplier). These represent 80%

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

of the forecasted equivalent Shares entitlement to be received (1,920 equivalent Shares represent 100%), with the final equivalent Shares entitlement to be determined when the new restaurants' 2020 actual sales performance is known with certainty in early 2021. See subsequent events – note 13.

PPL's Class D Equivalent Share entitlement is unchanged for 2020. In any year that the forecasted system sales (less closed restaurants sales and other adjustments) is negative, as was the case with the Class D Equivalent Share entitlement calculation for 2020, no increase or decrease in the Exchange Multiplier is made. PPL will only have a Class D Equivalent Share entitlement for 2020 if the actual sales performance of the one new Pizza 73 restaurant, less the sales of adjustment restaurants, significantly exceeds forecasted system sales and yields net, positive sales when the actual sales performance is known with certainty in early 2021. See subsequent events – note 13.

After giving effect to PPL's entitlement to additional equivalent Shares at January 1, 2020, PPL owns equivalent Shares representing 23.5% of the Company's fully diluted shares.

7. Income taxes

The provision for income taxes differs from that which would be obtained by applying the statutory tax rate as a result of the following:

| | December 31, 2020 | December 31, 2019 |
|--|----------------------|----------------------|
| | \$ | \$ |
| Earnings for the year before income taxes | 30,433 | 34,117 |
| Combined Canadian federal and provincial rates | 26.5% | 26.5% |
| Computed expected income tax expense | 8,065 | 9,041 |
| Partnership earnings allocated to PPL | (1,895) | (2,080) |
| Other | (211) | (149) |
| Income tax expense | 5,959 | 6,812 |

The components of the deferred tax liability are as follows:

| | December 31, 2020 | December 31, 2019 |
|---|----------------------|----------------------|
| | \$ | \$ |
| Pizza Pizza and Pizza 73 Rights and Marks | 22,075 | 21,185 |
| Interest rate swap | (434) | 358 |
| Deferred tax liability | 21,641 | 21,543 |

An analysis of the deferred tax liabilities is as follows:

| | December 31, 2020 | December 31, 2019 |
|---|----------------------|----------------------|
| | \$ | \$ |
| Deferred tax liabilities to be settled after more than a year | 21,641 | 21,543 |
| Deferred tax liabilities to be settled within a year | - | - |
| Deferred tax liability | 21,641 | 21,543 |

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The movement in the deferred tax liabilities is as follows:

| | December 31, 2020 \$ | December 31, 2019 \$ |
|---|----------------------------|----------------------------|
| Opening balance – deferred tax liability | 21,543 | 20,545 |
| Change in other comprehensive earnings – interest rate swap | (792) | 77 |
| Change in temporary differences | 890 | 921 |
| Deferred tax liability | 21,641 | 21,543 |

8. Share capital

a. Authorized

The Company is authorized to issue an unlimited number of common shares and an unlimited number of preference shares, issuable in series. As at December 31, 2020, 24,618,392 common shares and no preference shares are issued and fully paid. Each common share carries the right to one vote at meetings of shareholders, other than meetings of holders of another class of shares, and to participate equally and rateably in dividends of the Company, if any, and in the remaining property and assets of the Company upon its liquidation, dissolution or wind-up. Each series of preference shares issued shall have rights, privileges, restrictions and conditions as determined by the Board of Directors prior to their issuance. Preference shares may carry voting rights as determined by the Board of Directors and are entitled to a preference over the common shares in the remaining property and assets of the Company in the event of its liquidation, dissolution or wind-up.

b. Issued

The following is a summary of the activity during the year:

| | December 31, 2020 | | December 31, 2019 | |
|----------------------------|---------------------|----------------|---------------------|----------------|
| | Number of Shares | Amount \$ | Number of Shares | Amount \$ |
| Shares, beginning of year | 24,618,392 | 242,030 | 24,618,392 | 242,030 |
| Shares, end of year | 24,618,392 | 242,030 | 24,618,392 | 242,030 |

The Company's objectives when managing capital, which remained unchanged, are to:

- i) Safeguard its ability to continue as a going concern, so that it can continue to provide returns for shareholders and benefits for other stakeholders;
- ii) Provide an adequate return to shareholders while maintaining adequate reserves; and
- iii) Ensure sufficient liquidity to pursue its growth strategy while taking a conservative approach towards financial leverage and management of financial risk.

The Company evaluates its capital as all components of equity, other than amounts in accumulated other comprehensive earnings relating to the cash flow hedges.

The Company's amount of capital is set in proportion to risk. The Company manages its structure and makes adjustments in light of changes in economic conditions and risk characteristics of the underlying assets. The

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

Company's primary use of capital was to finance acquisitions, supported by the credit facility at the Partnership level.

c. Earnings per share

The basic earnings per share is calculated by dividing earnings for the period by the weighted average number of shares outstanding during the period. The denominator in basic earnings per share includes PPL's Class B and Class D Exchangeable Shares, as if they have been converted, since they are exchangeable into and economically equivalent to the Company's common shares. There were no potentially dilutive instruments outstanding during the years ended December 31, 2020 or 2019.

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

| | December 31, 2020 \$ | December 31, 2019 \$ |
|---|----------------------------|----------------------------|
| Weighted average number of: | | |
| Common shares | 24,618,392 | 24,618,392 |
| Exchangeable Shares (note 6) | 7,558,884 | 7,349,314 |
| Weighted average number of shares outstanding – basic and diluted | 32,177,276 | 31,967,706 |
| Basic and diluted earnings per share | \$0.76 | \$0.85 |

9. Royalty income

Royalty income earned by the Company has been derived as shown in the table below:

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Restaurants in Royalty Pool | 749 | 772 |
| System sales reported by Pizza Pizza restaurants in the Royalty Pool | 405,335 | 462,251 |
| System sales reported by Pizza 73 restaurants in the Royalty Pool | 82,987 | 91,235 |
| Total system sales | 488,322 | 553,486 |
| Royalty – 6% on Pizza Pizza system sales | 24,320 | 27,735 |
| Royalty – 9% on Pizza 73 system sales | 7,469 | 8,211 |
| Royalty income | 31,789 | 35,946 |

System sales do not represent the consolidated operating results of the Company but are used to calculate the royalty income as presented above.

10. Related party transactions and balances

PPL is a related party by virtue of holding Class B and Class D Exchangeable Shares that are exchangeable into Shares of the Company. Disclosure related to these Exchangeable Shares is provided in note 6.

PPL, pursuant to the Partnership Agreement, is providing certain administrative services to the Company. The fee for these services, which on an annual basis shall not exceed \$25, has been waived for the period.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The Company has a receivable from PPL as at December 31, 2020 of \$2,753 (December 31, 2019 – \$3,304) and a payable to PPL as at December 31, 2020 of \$644 (December 31, 2019 – \$694). The receivable relates to royalty amounts receivable from the Royalty Pool system sales, while the payable to PPL relates to distributions payable to PPL by virtue of holding Class B and Class D Exchangeable Shares and other expenses paid by PPL on behalf of the Partnership.

Transactions with related parties are in the normal course of operations. No amount of related party balances was written off during the years ended December 31, 2020 and 2019.

The Company has no paid executives in 2020 or 2019, but the total director compensation for the year ended December 31, 2020 was \$203 (December 31, 2019 - \$206).

11. Consolidated statements of cash flows information

Changes in non-cash working capital are as follows:

| | December 31, 2020 \$ | December 31, 2019 \$ |
|--|----------------------------|----------------------------|
| Receivable from Pizza Pizza Limited | 551 | (148) |
| Trade and other receivables | 15 | (16) |
| Trade and other payables | (64) | 30 |
| Payable to Pizza Pizza Limited | (50) | 7 |
| Income taxes payable | (141) | 130 |
| Changes in non-cash working capital | 311 | 3 |

12. Financial risk management

Fair value

The following table presents the carrying amount and the fair value of the Company's financial instruments. Amortized cost is calculated using the effective interest rate method. Fair value is estimated as disclosed below. These amounts represent point-in-time estimates and may not reflect fair value in the future. These calculations are subjective in nature, involve uncertainties and are a matter of significant judgment. The only financial instruments carried at fair value in the consolidated statements of financial position are the derivative financial instruments.

The carrying amounts of the cash, short-term investments, receivable from PPL, trade and other receivables, trade and other payables, dividends payable to shareholders, and payable to PPL all approximate their fair value given the short-term maturity of these financial instruments.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The carrying value and fair value of all financial instruments are as follows:

| | December 31, 2020 | | December 31, 2019 | |
|--|----------------------|------------------|----------------------|------------------|
| | Carrying value \$ | Fair value \$ | Carrying value \$ | Fair value \$ |
| Cash | 2,250 | 2,250 | 535 | 535 |
| Short-term investments | 2,750 | 2,750 | 2,750 | 2,750 |
| Receivable from Pizza Pizza Limited | 2,753 | 2,753 | 3,304 | 3,304 |
| Trade and other receivables | 76 | 76 | 91 | 91 |
| Derivative financial instruments - asset | - | - | 510 | 510 |
| Trade and other payables | 417 | 417 | 481 | 481 |
| Payable to Pizza Pizza Limited | 644 | 644 | 694 | 694 |
| Dividends payable to shareholders | 1,354 | 1,354 | 1,755 | 1,755 |
| Borrowings | 46,924 | 47,000 | 46,909 | 47,000 |
| Derivative financial instruments - liability | 2,138 | 2,138 | - | - |

The different fair value hierarchy levels are as follows:

- Level 1: Quoted prices (unadjusted) in active markets for identical financial assets or financial liabilities;
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the financial asset or financial liability, either directly or indirectly; and
- Level 3: Inputs for the financial assets or financial liabilities that are not based on observable market data.

As at December 31, 2020, inputs used to fair value the derivative financial instruments were Level 2 and based on observable inputs available for similar assets and liabilities in the active markets, as provided by sources independent from the Company.

The fair value of the borrowings balance, which equals the principal amount outstanding, is \$47 million (December 31, 2019 – \$47 million) since the debt has variable interest rates at terms that the Company believes are reflective of currently available terms. The Company has no plans to prepay these instruments prior to maturity. The valuation is determined using Level 2 inputs, which are observable inputs or inputs that can be corroborated by observable market data for substantially the full term of the asset or liability.

Credit risk

The Company is exposed to credit risk in the event of non-payment by PPL and due to the fact that PPL's operations are all within the same segment, commercial food services. The credit risk is mitigated since monthly royalty payments are received from PPL based on sales generated by a large number of Pizza Pizza and Pizza 73 restaurants in diverse geographical regions. These royalty payments are used to fund monthly distributions to the Company on its Class A and C Limited Partnership Units and to fund distributions to PPL on its Class B and D Partnership Units. All trade and other receivables, and the amount receivable from PPL, are current and no amounts have been written off or provided for during the year.

Credit risk also arises from cash and derivative financial instruments with banks and financial institutions. The Company places its cash and transacts in derivative financial instruments with institutions of high creditworthiness.

Maximum credit risk exposure, which is equivalent to the carrying amount, represents the loss that would be incurred if all of the Company's counterparties were to default at the same time.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

Liquidity risk

The Company is subject to liquidity risk with respect to trade and other payables, borrowings, provision for other charges and funding the dividends payable to Company shareholders. The Company receives monthly royalties from PPL, and the Company is of the opinion that this risk is mitigated by the large number of Pizza Pizza and Pizza 73 restaurants in diverse geographical areas that generate the royalties used to fund the monthly royalties. To mitigate its liquidity risk, the Company has the discretion to reduce the dividends payable to the Company's shareholders in the event of a reduction of the Company's royalty income.

The dividends payable to Company shareholders and trade and other payables, are expected to be paid within 30 days of the date of the consolidated statements of financial position.

Interest rate risk

The interest rate swaps eliminate the Company's interest rate cash flow risk by fixing the rate of interest that is paid on the borrowings. However, the Company is still exposed to fair value interest rate risk as a result of fair value movements in the value of the interest rate swaps that are recorded in other comprehensive earnings (loss) to the extent that the interest rate swaps are highly effective as cash flow hedges. If interest rates changed by plus/minus 10% of the existing rate, total comprehensive earnings and equity would change by plus/minus \$363 as at December 31, 2020 (December 31, 2019 – \$490) based on movements in the fair value of the interest rate swaps.

In April 2020, the Company's previous interest rate swaps expired. As a result, the remaining hedge reserve of \$502 was reclassified from accumulated other comprehensive income to the statement of earnings. This reclassification does not represent a cash inflow during the year. The Company's new swaps became effective in April 2020 (note 5).

13. Subsequent events

The chart below shows the Company shares that would be outstanding if all of the Class B and Class D Units held by PPL were converted to Company shares after accounting for their respective multipliers and adjustments as described below, after the impact of the January 1, 2021 Adjustment Date.

| Shares outstanding & issuable on January 1, 2021 | | |
|---|-----------|-------------------|
| Shares outstanding | | 24,618,392 |
| Class B equivalent Shares held by PPL at December 31, 2020 | 5,313,909 | |
| PPL additional Class B Equivalent Shares - True-up Holdback as at December 31, 2020 | - | |
| Additional PPL Class B equivalent Shares as of January 1, 2021 | <u>-</u> | 5,313,909 |
| Class D equivalent Shares held by PPL at December 31, 2020 | 2,244,975 | |
| PPL additional Class D Equivalent Shares - True-up Holdback as at December 31, 2020 | - | |
| Additional PPL Class D equivalent Shares as of January 1, 2021 | <u>-</u> | 2,244,975 |
| Number of fully diluted shares | | <u>32,177,276</u> |
| | | 23.5% |

a. 2020 Royalty Pool Adjustment

In early January 2021 a second adjustment was made to the royalty payments and PPL's Class B Exchange Multiplier based on the actual performance of the 19 new restaurants added to the Royalty Pool on January

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

1, 2020. The final 2020 Pizza Pizza Royalty Pool adjustment resulted in a Make-Whole Payment being made on \$781 of Royalty Pool sales. The Make-Whole Payment will continue to be paid for subsequent years, until on an Adjustment Date, additional system sales of additional restaurants are sufficient to offset the Pizza Pizza system sales attributable to all closed Pizza Pizza restaurants. As a result of the adjustments, the Class B Exchange Multiplier is unchanged at 2.118582 and Class B Units can be exchanged for 5,313,909 shares effective January 1, 2020.

In early January 2021, a second adjustment was made to the royalty payments and PPL's Class D Exchange Multiplier based on the actual performance of the one Pizza 73 restaurant added to the Royalty Pool on January 1, 2020. The final 2020 Pizza 73 Royalty Pool adjustment resulted in a Make-Whole Payment being made on \$692 of Royalty Pool sales. The Make-Whole Payment will continue to be paid for subsequent years, until on an Adjustment Date, additional system sales of additional restaurants are sufficient to offset the Pizza Pizza system sales attributable to all closed Pizza 73 restaurants. As a result of the adjustments, the Class D Exchange Multiplier is unchanged at 22.44976 and Class D Units can be exchanged for 2,244,975 shares effective January 1, 2020.

b. 2021 Royalty Pool Adjustment – Class B Exchange Multiplier

On January 1, 2021, 23 net Pizza Pizza restaurants were removed from the Royalty Pool as a result of nine new restaurants opening and 32 closing from January 1, 2020 to December 31, 2020. The total number of Pizza Pizza restaurants in the Royalty Pool has decreased to 622. The additional system sales from the nine new restaurants are estimated at \$4,056 annually, less sales of \$18,572 from the 32 permanently closed Pizza Pizza restaurants. As a result, a negative \$14,516 net, estimated Pizza Pizza sales were removed from the Royalty Pool.

Since the system sales of the closed Pizza Pizza restaurants exceeded the additional system sales of the additional restaurants added to the Pizza Pizza Royalty Pool, the Make-Whole Payment paid by PPL to the Partnership will be carried over, and continue to be paid for subsequent years, until on an Adjustment Date, additional system sales of additional restaurants are sufficient to offset the Pizza Pizza system sales attributable to all closed Pizza Pizza restaurants.

The yield of the shares was determined to be 7.3% calculated using \$9.18 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2021. As per the Pizza Pizza Royalty Limited Partnership agreement, whenever the Estimated Determined Amount is negative it shall be deemed to be zero. Accordingly, the Class B Exchange Multiplier remained unchanged at 2.118582. The second adjustment to the Class B Exchange Multiplier will be adjusted to be effective January 1, 2021, once the actual performance of the new restaurant is determined in early 2022.

c. 2021 Royalty Pool Adjustment – Class D Exchange Multiplier

On January 1, 2021, one net Pizza 73 restaurant was removed from the Royalty Pool as a result of one new restaurant opening between September 2, 2019 and September 1, 2020 and two restaurants closing between January 1, 2020 and December 31, 2020. The forecasted additional system sales from the one new restaurant is estimated at \$520 annually, less \$1,054 in system sales attributable to the two closed Pizza 73 restaurants. As a result, a negative \$534 net, estimated Pizza 73 sales were removed from the Royalty Pool. The total number of Pizza 73 restaurants in the Royalty Pool has decreased to 103.

Since the system sales of the closed Pizza 73 restaurants exceeded the additional system sales of the additional restaurant added to the Pizza 73 Royalty Pool, the Make-Whole Payment paid by PPL to the Partnership will be carried over, and continue to be paid for subsequent years, until on an Adjustment Date, additional system sales of additional restaurants are sufficient to offset the Pizza 73 system sales attributable to all closed Pizza 73 restaurants.

Pizza Pizza Royalty Corp.

Notes to the Consolidated Financial Statements

For the years ended December 31, 2020 and 2019

(Expressed in thousands of Canadian dollars, except number of shares and per share amounts)

The yield of the shares was determined to be 7.3% calculated using \$9.18 as a weighted average share price. Weighted average share price is calculated based on the market price of the shares traded on the Toronto Stock Exchange during the period of twenty consecutive days ending on the fifth trading day before January 1, 2021. As per the Pizza Pizza Royalty Limited Partnership agreement, whenever the Estimated Determined Amount is negative it shall be deemed to be zero. Accordingly, the Class D Exchange Multiplier remained unchanged at 22.44976. The second adjustment to the Class D Exchange Multiplier will be adjusted to be effective January 1, 2021, once the actual performance of the new restaurant is determined in early 2022.

d. Pizza Pizza Royalty Corp. Outstanding Shares

PPL's Class B and Class D equivalent Share entitlement is unchanged for 2021. In any year that the forecasted system sales (less closed restaurants sales and other adjustments) is negative, as was the case with the Class B and Class D equivalent Share entitlement calculation for 2021, no increase or decrease in the Exchange Multiplier is made. PPL will only have a Class B or D equivalent Share entitlement for 2021 if the actual sales performance of the new restaurants, less the sales of adjustment restaurants, significantly exceeds forecasted system sales and yields net, positive sales when the actual sales performance is known with certainty in early 2022.

After giving effect to PPL's entitlement to additional equivalent Shares at January 1, 2021, PPL owns equivalent Shares representing 23.5% of the Company's fully diluted shares.