

U.S. SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

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

For the transition period from

Commission File No. 000-53577

DIVERSIFIED RESTAURANT HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

Nevada

03-0606420

(State or other jurisdiction
of incorporation or organization)

(I.R.S. Employer
Identification Number)

27680 Franklin Road
Southfield, Michigan 48034
(Address of principal executive offices)

Registrant's telephone number: (833) 374-7282

No change
(Former name, former address and former
fiscal year, if changed since last report)

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

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

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

| | | | |
|-------------------------|-------------------------------------|---------------------------|-------------------------------------|
| Large accelerated filer | <input type="checkbox"/> | Accelerated filer | <input type="checkbox"/> |
| Non-accelerated filer | <input checked="" type="checkbox"/> | Smaller reporting company | <input checked="" type="checkbox"/> |
| | | Emerging growth company | <input type="checkbox"/> |

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 32,576,887 shares of \$.0001 par value common stock outstanding as of November 6, 2018 .

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****DIVERSIFIED RESTAURANT HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS (unaudited)**

| ASSETS | September 30, 2018 | December 31, 2017 |
|---|-----------------------|-----------------------|
| Current assets | | |
| Cash and cash equivalents | \$ 7,109,781 | \$ 4,371,156 |
| Accounts receivable | 304,339 | 653,102 |
| Inventory | 1,407,119 | 1,591,363 |
| Prepaid and other assets | 497,378 | 408,982 |
| Total current assets | 9,318,617 | 7,024,603 |
| Property and equipment, net | 39,160,338 | 48,014,043 |
| Intangible assets, net | 2,219,698 | 2,438,187 |
| Goodwill | 50,097,081 | 50,097,081 |
| Other long-term assets | 967,574 | 185,322 |
| Total assets | \$ 101,763,308 | \$ 107,759,236 |
| LIABILITIES AND STOCKHOLDERS' DEFICIT | | |
| Current liabilities | | |
| Accounts payable | \$ 3,727,263 | \$ 4,561,939 |
| Accrued compensation | 2,478,886 | 1,854,127 |
| Other accrued liabilities | 3,090,820 | 2,404,942 |
| Current portion of long-term debt | 11,513,280 | 11,440,433 |
| Current portion of deferred rent | 424,044 | 411,660 |
| Total current liabilities | 21,234,293 | 20,673,101 |
| Deferred rent, less current portion | 2,392,669 | 2,208,238 |
| Deferred income taxes | 2,017,015 | 2,759,870 |
| Unfavorable operating leases | 450,712 | 510,941 |
| Other long-term liabilities | 1,795,725 | 2,346,991 |
| Long-term debt, less current portion | 93,787,074 | 102,488,730 |
| Total liabilities | 121,677,488 | 130,987,871 |
| Commitments and contingencies (Notes 3, 10 and 11) | | |
| Stockholders' deficit : | | |
| Common stock - \$0.0001 par value; 100,000,000 shares authorized; 32,577,262 and 26,859,125, respectively, issued and outstanding | 3,179 | 2,625 |
| Additional paid-in capital | 26,849,631 | 21,776,402 |
| Accumulated other comprehensive income (loss) | 667,217 | (283,208) |
| Accumulated deficit | (47,434,207) | (44,724,454) |
| Total stockholders' deficit | (19,914,180) | (23,228,635) |
| Total liabilities and stockholders' deficit | \$ 101,763,308 | \$ 107,759,236 |

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

DIVERSIFIED RESTAURANT HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS (unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 30, 2018 | September 24, 2017 | September 30, 2018 | September 24, 2017 |
| Revenue | \$ 37,491,751 | \$ 39,262,940 | \$ 114,063,781 | \$ 123,535,066 |
| Operating expenses | | | | |
| Restaurant operating costs (exclusive of depreciation and amortization shown separately below): | | | | |
| Food, beverage, and packaging costs | 10,692,796 | 11,569,925 | 32,388,212 | 36,529,901 |
| Compensation costs | 10,279,281 | 9,991,381 | 30,611,334 | 31,125,287 |
| Occupancy costs | 2,912,507 | 2,969,250 | 8,662,717 | 8,701,927 |
| Other operating costs | 8,461,334 | 8,770,406 | 24,817,359 | 26,188,432 |
| General and administrative expenses | 2,001,343 | 2,301,061 | 6,361,084 | 6,724,436 |
| Pre-opening costs | — | 79,605 | — | 405,448 |
| Depreciation and amortization | 2,908,608 | 3,244,255 | 9,175,853 | 10,149,050 |
| Impairment and loss on asset disposal | 918,399 | 16,578 | 931,196 | 302,652 |
| Total operating expenses | 38,174,268 | 38,942,461 | 112,947,755 | 120,127,133 |
| Operating (loss) profit | (682,517) | 320,479 | 1,116,026 | 3,408,373 |
| Interest expense | (1,609,277) | (1,822,876) | (4,865,308) | (5,041,136) |
| Other income, net | 24,778 | 26,000 | 77,994 | 78,307 |
| Loss from continuing operations before income taxes | (2,267,016) | (1,476,397) | (3,671,288) | (1,554,456) |
| Income tax benefit of continuing operations | 505,644 | 933,157 | 961,535 | 1,515,453 |
| Loss from continuing operations | (1,761,372) | (543,240) | (2,709,753) | (39,003) |
| Discontinued operations | | | | |
| Loss from discontinued operations before income taxes | — | (22,960) | — | (155,552) |
| Income tax benefit of discontinued operations | — | 7,806 | — | 58,191 |
| Loss from discontinued operations | — | (15,154) | — | (97,361) |
| Net loss | \$ (1,761,372) | \$ (558,394) | \$ (2,709,753) | \$ (136,364) |
| Basic earnings per share from: | | | | |
| Continuing operations | \$ (0.06) | \$ (0.02) | \$ (0.10) | \$ — |
| Discontinued operations | — | — | — | — |
| Basic net earnings per share | \$ (0.06) | \$ (0.02) | \$ (0.10) | \$ — |
| Diluted earnings per share from: | | | | |
| Continuing operations | \$ (0.06) | \$ (0.02) | \$ (0.10) | \$ — |
| Discontinued operations | — | — | — | — |
| Diluted net earnings per share | \$ (0.06) | \$ (0.02) | \$ (0.10) | \$ — |
| Weighted average number of common shares outstanding | | | | |
| Basic | 30,643,240 | 26,764,776 | 27,990,420 | 26,672,057 |
| Diluted | 30,643,240 | 26,764,776 | 27,990,420 | 26,672,057 |

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

DIVERSIFIED RESTAURANT HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS) (unaudited)

| | <u>Three Months Ended</u> | | <u>Nine Months Ended</u> | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | <u>September 30, 2018</u> | <u>September 24, 2017</u> | <u>September 30, 2018</u> | <u>September 24, 2017</u> |
| Net loss | \$ (1,761,372) | \$ (558,394) | \$ (2,709,753) | \$ (136,364) |
| Other comprehensive income | | | | |
| Unrealized changes in fair value of interest rate swaps, net of tax of \$166,380, (\$150,926), \$252,619 and (\$71,576), respectively. | 4,241 | 292,974 | 950,425 | 138,941 |
| Total other comprehensive income | 4,241 | 292,974 | 950,425 | 138,941 |
| Comprehensive income (loss) | \$ (1,757,131) | \$ (265,420) | \$ (1,759,328) | \$ 2,577 |

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

DIVERSIFIED RESTAURANT HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' DEFICIT (unaudited)

| | Common Stock | | Additional Paid-in Capital | Accumulated Other Comprehensive Loss | Accumulated Deficit | Total Stockholders' Deficit |
|---|-------------------|-----------------|----------------------------------|---|------------------------|-----------------------------------|
| | Shares | Amount | | | | |
| Balances - December 31, 2017 | 26,859,125 | \$ 2,625 | \$ 21,776,402 | \$ (283,208) | \$ (44,724,454) | \$ (23,228,635) |
| Issuance of restricted shares | 375,119 | — | — | — | — | — |
| Forfeitures of restricted shares | (34,921) | — | — | — | — | — |
| Shares effectively repurchased for required withholding taxes | (50,163) | (5) | (70,346) | — | — | (70,351) |
| Issuance of common shares from offering, net of fees and expenses of \$.7 million | 5,300,000 | 530 | 4,579,251 | — | — | 4,579,781 |
| Employee stock purchase plan | 47,078 | 5 | 58,915 | — | — | 58,920 |
| Share-based compensation | 81,024 | 24 | 505,409 | — | — | 505,433 |
| Other comprehensive income | — | — | — | 950,425 | — | 950,425 |
| Net loss from continuing operations | — | — | — | — | (2,709,753) | (2,709,753) |
| Balances - September 30, 2018 | 32,577,262 | \$ 3,179 | \$ 26,849,631 | \$ 667,217 | \$ (47,434,207) | \$ (19,914,180) |

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

DIVERSIFIED RESTAURANT HOLDINGS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

| | Nine Months Ended | |
|--|---------------------|---------------------|
| | September 30, 2018 | September 24, 2017 |
| Cash flows from operating activities | | |
| Net loss | \$ (2,709,753) | \$ (136,364) |
| Net loss from discontinued operations | — | (97,361) |
| Net loss from continuing operations | (2,709,753) | (39,003) |
| Adjustments to reconcile net loss from continuing operations to net cash provided by operating activities: | | |
| Depreciation and amortization | 9,175,853 | 10,149,050 |
| Amortization of debt discount and loan fees | 231,392 | 156,951 |
| Amortization of gain on sale-leaseback | (156,107) | (99,657) |
| Impairment and loss on asset disposals | 931,196 | 302,652 |
| Share-based compensation | 505,433 | 284,100 |
| Deferred income taxes | (985,393) | (1,573,644) |
| Changes in operating assets and liabilities that provided (used) cash | | |
| Accounts receivable | 348,763 | 172,395 |
| Inventory | 184,244 | 196,987 |
| Prepaid and other assets | (88,396) | 134,593 |
| Intangible assets | (20,000) | (28,729) |
| Other long-term assets | (8,312) | 46,455 |
| Accounts payable | (753,767) | 1,228,025 |
| Accrued liabilities | 1,274,271 | (1,270,506) |
| Deferred rent | 196,815 | 137,342 |
| Net cash provided by operating activities of continuing operations | 8,126,239 | 9,797,011 |
| Net cash used in operating activities of discontinued operations | — | (97,361) |
| Net cash provided by operating activities | 8,126,239 | 9,699,650 |
| Cash flows from investing activities | | |
| Purchases of property and equipment | (1,276,122) | (4,453,861) |
| Net cash used in investing activities | (1,276,122) | (4,453,861) |
| Cash flows from financing activities | | |
| Proceeds from issuance of long-term debt | — | 4,650,965 |
| Repayments of long-term debt | (8,679,842) | (9,237,466) |
| Issuance of common stock, net of fees and expenses of \$.7 million | 4,579,781 | — |
| Proceeds from employee stock purchase plan | 58,920 | 45,005 |
| Tax withholdings for restricted stock | (70,351) | (59,928) |
| Net cash used in financing activities | (4,111,492) | (4,601,424) |
| Net increase in cash and cash equivalents | 2,738,625 | 644,365 |
| Cash and cash equivalents, beginning of period | 4,371,156 | 4,021,126 |
| Cash and cash equivalents, end of period | \$ 7,109,781 | \$ 4,665,491 |

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

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

1. NATURE OF BUSINESS, BASIS OF PRESENTATION AND SIGNIFICANT TRANSACTION

Nature of Business

Diversified Restaurant Holdings, Inc. ("DRH" or the "Company") is a restaurant company operating a single concept, Buffalo Wild Wings® ("BWW"). As one of the largest franchisees of BWW, we provide a unique guest experience in a casual and inviting environment.

DRH currently operates 64 BWW restaurants (20 in Michigan, 17 in Florida, 15 in Missouri, 7 in Illinois and 5 in Indiana), including the nation's largest BWW, based on square footage, in downtown Detroit, Michigan.

On December 25, 2016, the Company completed a spin-off (the "Spin-Off") of 19 Bagger Dave's entities and certain real estate entities which house the respective Bagger Dave's entities previously owned by DRH into a new independent publicly traded company, Bagger Dave's Burger Tavern, Inc. ("Bagger Dave's"). For additional details refer to Note 2 .

Basis of Presentation

The consolidated financial statements as of September 30, 2018 and December 31, 2017 , and for the three and nine -month periods ended September 30, 2018 and September 24, 2017 , have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") and the rules and regulations of the Securities and Exchange Commission ("SEC"). The financial information as of September 30, 2018 and for the nine -month periods ended September 30, 2018 and September 24, 2017 is unaudited, but, in the opinion of management, reflects all adjustments and accruals necessary for a fair presentation of the financial position, results of operations, and cash flows for the interim periods. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated.

The consolidated financial information as of December 31, 2017 is derived from our audited consolidated financial statements and notes thereto for the fiscal year ended December 31, 2017 , which is included in Item 8 in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017 , and should be read in conjunction with such consolidated financial statements.

The results of operations for the nine -month periods ended September 30, 2018 and September 24, 2017 are not necessarily indicative of the results of operations that may be achieved for the entire fiscal year ending December 30, 2018 .

Our significant accounting policies are disclosed in Part II, Item 8, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2017 .

Since December 31, 2017 , there has been one significant change in our accounting policies related to revenue recognition, which is presented below.

Revenue Recognition Policy

Revenue is measured based on consideration specified in implied contracts with our customers and excludes amounts collected on behalf of third parties. The Company recognizes revenue when it satisfies a performance obligation (at the time of sale) by transferring control over a product to a customer. Payment is due at the time the food or merchandise is transferred to the customer. The portion of any sale that results in loyalty rewards being issued is deferred, net of estimated breakage, until redemption.

Nature of Goods Sold

DRH earns revenue through sales of food, gift cards and merchandise to our customers. These sales occur through multiple channels, such as in-restaurant, call-in, online (web-based) and via third party delivery services.

Buffalo Wild Wings International, Inc. ("BWLD") offers a system-wide loyalty program (Blazin' Rewards®) whereby enrolled customers earn points for each qualifying purchase. As a franchisee, DRH is required to participate in the program. DRH estimates the value of loyalty points earned (the value per point) by dividing the menu price of redeemable items by the loyalty reward points required to redeem that menu item. Points issued as part of the loyalty program expire after 6 months of member inactivity. DRH commissioned a study to determine a reasonable estimate of the breakage rate, which was approximately 32% .

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

DRH has two types of sales transactions, transactions without loyalty attachment and transactions with loyalty attachment. Transactions without loyalty attachment require no allocation of the transaction price, because the price is observable and fixed based on the menu. Transactions with loyalty attachment have two performance obligations: 1) providing the purchased food and/or merchandise to the customer and, 2) redeeming awarded loyalty points for food or merchandise in the future. In loyalty related transactions the price is allocated to the products sold and the points issued. Revenue related to loyalty points that may be redeemed in the future is deferred, net of estimated breakage, until such loyalty points are redeemed. For additional details refer to Note 6 .

The Company offers gift cards for purchase through a BWLD system-wide program. Gift cards sold are recorded as a liability to BWLD. When redeemed, the gift card liability is offset by recording the transaction as revenue. Net gift card activity is settled with BWLD weekly. At times, gift card redemptions may exceed amounts due to BWLD for gift card purchases, resulting in an asset balance. Because this is a system-wide program operated by BWLD, the Company is not impacted by and does not record breakage.

Disaggregation of Revenue

In the following table, revenue is disaggregated by product mix.

Disaggregated Revenue

| Product | Three Months Ended September 30, 2018 | Three Months Ended September 24, 2017 |
|----------------|--|--|
| Food | \$ 31,394,837 | \$ 32,893,804 |
| Alcohol | 6,096,914 | 6,369,136 |
| Total | <u>\$ 37,491,751</u> | <u>\$ 39,262,940</u> |

| Product | Nine Months Ended September 30, 2018 | Nine Months Ended September 24, 2017 |
|----------------|---|---|
| Food | \$ 95,404,774 | \$ 103,521,105 |
| Alcohol | 18,659,007 | 20,014,401 |
| Total | <u>\$ 114,063,781</u> | <u>\$ 123,535,506</u> |

Recent Accounting Pronouncements

In August 2017, the Financial Accounting Standards Board (FASB) issued ASU No. 2017-12, *Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities (Topic 815)* ("ASU 2017-12"). The amendment expands an entity's ability to hedge accounting to non-financial and financial risk components and requires changes in fair value of hedging instruments to be presented in the same income statement line as the hedged item. The ASU also amends the presentation and disclosure requirements for the effect of hedge accounting. The ASU must be adopted using a modified retrospective approach with a cumulative effect adjustment recorded to the opening balance of retained earnings as of the initial application date. The ASU is effective for fiscal years beginning after December 15, 2018 and interim periods therein. Early adoption is permitted. The Company is in the process of assessing the impact of this ASU on its consolidated results of operations, cash flows, financial position and disclosures.

In February 2016, FASB issued ASU No. 2016-02, *Leases* ("ASU 2016-02"). ASU 2016-02 requires that lease arrangements longer than 12 months result in a lessee recognizing a lease asset and liability. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. The updated guidance is effective for interim and annual periods beginning after December 15, 2018, and early adoption is permitted. We have analyzed the impact of the new standard and concluded that the adoption of ASU 2016-02 will materially impact our consolidated financial statements by significantly increasing our non-current assets and liabilities on our consolidated balance sheets in order to record the right of use assets and related lease liabilities for our existing operating leases. We lease all of our restaurant properties, and operating leases comprise the majority of our current lease portfolio. With respect to implementation, we are currently reviewing the accounting standard and expect it to have a material impact on our consolidated financial statements.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

We reviewed all other significant newly-issued accounting pronouncements and concluded that they either are not applicable to our operations or that no material effect is expected on our consolidated financial statements as a result of future adoption.

Recently Adopted Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09, *Revenue with Contracts from Customers (Topic 606)* ("ASU 2014-09"). ASU 2014-09 supersedes the current revenue recognition guidance, including industry-specific guidance. This ASU and subsequently issued amendments, introduce a five-step model to achieve its core principal of the entity recognizing revenue to depict the transfer of goods or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In August 2015, the FASB issued ASU No. 2015-14, *Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date*, which delayed the effective date of ASU 2014-09 for public companies to January 1, 2018. The FASB also agreed to allow entities to choose to adopt the standard as of the original effective date.

The requirements for these standards relating to Topic 606 are effective for interim and annual periods beginning after December 15, 2017. The Company adopted ASU 2014-09 effective as of January 1, 2018, using the modified retrospective transition method to all existing contracts that were not substantially completed at the adoption date. We finalized our analysis and the adoption of ASU 2014-09 which did not have, and is not expected to have, a material impact on the timing or amount of revenue recognized as compared to the Company's previous revenue recognition practices, or our internal controls over financial reporting.

Significant Transaction

On July 24, 2018 the Company completed an underwritten registered public offering of 6 million shares of common stock at a public offering price of \$1.00 per share, which included 700,000 shares offered by a certain selling stockholder, for total Company gross proceeds of \$5.3 million. The net proceeds from the Offering were approximately \$4.6 million, after deducting the underwriting discounts and commissions and offering expenses payable by us. We intend to use the net proceeds from the offering for working capital and general corporate purposes, which may include repayment of debt.

The offering was made pursuant to a shelf registration statement on Form S-3 (File No. 333-225457) that was filed with the SEC and became effective on July 5, 2018. A prospectus supplement and accompanying prospectus relating to and describing the terms of the offering were filed with the SEC on July 23, 2018.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

2. DISCONTINUED OPERATIONS

Spin-Off of Bagger Dave's

On August 4, 2016, DRH announced that its Board of Directors unanimously approved a plan to pursue a tax-free spin-off of its Bagger Dave's business. Pursuant to this plan, DRH contributed its 100.0% owned entity, AMC Burgers, LLC and certain real estate entities, into Bagger Dave's Burger Tavern, Inc., a newly created Nevada company, which was then spun-off into a stand-alone company. AMC Burgers, Inc. owned and operated all of the Bagger Dave's Burger Tavern[®] restaurants and the real estate entities held certain real estate related to the restaurants before the real estate was sold in 2014 and 2015. In connection with the Spin-Off, DRH contributed certain assets, liabilities and employees related to its Bagger Dave's businesses. Intercompany balances due to/from DRH, which included amounts from sales, were contributed to equity of Bagger Dave's. The Spin-Off was effected on December 25, 2016 via a one-for-one distribution of common shares in Bagger Dave's to DRH holders of record on December 19, 2016. As part of the Spin-Off transaction, DRH funded a one-time \$2.0 million cash distribution to Bagger Dave's.

Prior to the Spin-Off, Bagger Dave's was a co-obligor on a joint and several basis with the Company on its \$155.0 million senior secured credit facility. The Company's debt under this facility remained with the Company and Bagger Dave's was released as a borrower. As a result, this debt was not assigned to discontinued operations. Additionally, DRH retained substantially all of the tax benefits (net operating loss and tax credit carryforwards) generated by Bagger Dave's prior to the date of the transaction.

DRH decided to spin-off Bagger Dave's after considering all reasonable strategic and structural alternatives because of the disparity between the operating models of its two brands, BWW as franchisee, and Bagger Dave's as an owned concept. The management teams of Bagger Dave's and DRH agreed that the nature of the two concepts varied greatly, and that each would be more valuable and operate more effectively independently of one another. Bagger Dave's is a concept developed by the management team of DRH. In contrast to operating a franchised concept like BWW, it has no development restrictions and the flexibility to enhance brand attributes such as logos, trade dress and restaurant design, change its menu offering and improve its operational model in an effort to better align with guest expectations. To manage these functions effectively, specific resources are required that are not necessary for a franchisee. For example, menu development, purchasing and brand marketing are critical to the success of Bagger Dave's but not necessary for a BWW franchisee since these functions are managed by the franchisor. Additionally, as a start-up brand, Bagger Dave's has both higher risk and higher growth potential while BWW, being a mature brand and as a franchisee, has more limited organic growth potential due to the status of its existing market penetration and the need to obtain development rights from the franchisor.

In conjunction with the Spin-Off, DRH entered into a transition services agreement (the "TSA") with Bagger Dave's pursuant to which DRH provided certain information technology and human resources support, limited accounting support, and other minor administrative functions at no charge. The TSA was intended to assist the discontinued component in efficiently and seamlessly transitioning to stand on its own. Certain provisions of the TSA terminated in December 2017 and the First Amendment to TSA (the "Amended TSA") was entered into effective January 1, 2018. Under the Amended TSA, DRH provides ongoing administrative support to Bagger Dave's in certain areas, including information technology, human resources and real estate, in exchange for a fee based on a rate-per-hour of service. The amount charged to Bagger Dave's was \$11,940 and \$0, \$39,300 and \$0 during the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017, respectively.

Information related to the Bagger Dave's Spin-Off has been reflected in the accompanying consolidated financial statements as follows:

- Consolidated Statements of Operations - Bagger Dave's results of operations for the three and nine month period ended September 24, 2017 have been presented as discontinued operations. There was no activity related to the discontinued operation at the Company for the three and nine month period ended September 30, 2018.
- Consolidated Statements of Cash Flows - The Bagger Dave's cash flows from operating and investing activities for the nine-month period ended September 24, 2017 have been presented separately on the face of the cash flow statement. There was no activity related to the discontinued operation at the Company for the three and nine month period ended September 30, 2018.

The operating results of the discontinued operations include only direct expenses incurred by Bagger Dave's. Discontinued operations exclude certain corporate functions that were previously allocated to Bagger Dave's. Interest expense was not allocated to discontinued operations because the Company's debt under the \$155 million secured credit facility remained with the Company.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Prior to the Spin-Off, Bagger Dave's was a reportable segment of the Company. Following the Spin-Off, there were no assets or liabilities remaining from the Bagger Dave's operations as of December 25, 2016. See Note 3 for a discussion of involvement the Company will continue to have with Bagger Dave's after the Spin-Off.

3. UNCONSOLIDATED VARIABLE INTEREST ENTITIES

After the Spin-Off of Bagger Dave's and the related discontinuation of its operations described in Note 2, the Company remains involved with certain activities that result in Bagger Dave's being considered a Variable Interest Entity ("VIE"). This conclusion results primarily from the existence of guarantees by the Company of certain Bagger Dave's leases as described below under "Lease Guarantees". While the Company holds a variable interest in Bagger Dave's, it is not considered to be its primary beneficiary because it does not have the power to direct the activities of Bagger Dave's. Specifically, we considered the fact that, although our Executive Chairman is currently also on Bagger Dave's board, there are no agreements in place that require him to vote in the interests of the Company, as he does not represent the Company in his capacity as a Bagger Dave's director.

Lease Guarantees

At September 30, 2018, the Company is a guarantor for 12 leases, four of which have been re-leased to unaffiliated parties. In the event the respective lessees cannot make their lease payments, the Company may become responsible for the payments under its guarantee.

Upon the Spin-Off of Bagger Dave's, in accordance with ASC 460, *Guarantees*, the Company evaluated its liability from the lease guarantees first by estimating the non-contingent component representing the estimated fair market value of the guarantees at inception, and recorded a liability. As of September 30, 2018 and December 31, 2017, the liability is \$0.3 million, and it is included in other liabilities on the Consolidated Balance Sheet. Prior to December 25, 2017, no liability had been recorded as a result of the affiliate relationship between the Company and Bagger Dave's.

Secondly, the Company considered the contingent component of the guarantees and concluded that, as of September 30, 2018 and December 31, 2017, no loss under the guarantees was probable because all but one of the Bagger Dave's restaurants subject to the guaranteed leases is either currently operating or the site has been leased to another tenant who is responsible for, and making, the lease payments. With respect to the one Bagger Dave's location that has been closed and not re-leased, Bagger Dave's is continuing to make the lease payments while it either seeks a new tenant for the site or negotiates an exit from the liability with the landlord.

The Company has determined that its maximum exposure resulting from the lease guarantees includes approximately \$7.6 million of future minimum lease payments plus potential additional payments to satisfy maintenance, property tax and insurance requirements under the leases as of September 30, 2018. The terms and conditions of the guarantees vary, and each guarantee has an expiration date which may or may not correspond with the end of the underlying lease term. The guarantee expiration dates range from less than 2 months to 12 years as of September 30, 2018. In the event that the Company is required to perform under any of its lease guarantees, we do not believe the liability would be material because we would first seek to minimize the exposure by finding a suitable tenant to lease the space. In many cases, we expect that a replacement tenant would be found. In reaching our conclusion, we also considered the following:

- the financial condition of Bagger Dave's, including its ability to service the lease payments on the locations it continues to operate;
- its history of incurring operating losses;
- its liquidity position and the actions available to it should its liquidity deteriorate to such a degree that its ability to service required lease payments is threatened; and
- the actions available to the Company to avoid or mitigate potential losses should Bagger Dave's become unable to service one or more of the leases that the Company guarantees.

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The following is a detailed listing of all Bagger Dave's leases that include a guarantee by the Company as of September 30, 2018 :

| Location of lease | Status of location | Guarantee expiry date | Future guaranteed lease payments |
|---------------------------|--------------------|-----------------------|----------------------------------|
| Woodhaven, MI | Closed / re-leased | 11/30/18 | \$ 12,367 |
| Traverse City, MI | Closed | 01/31/19 | 31,667 |
| Fort Wayne, IN | Open | 01/31/19 | 28,757 |
| Grand Blanc, MI | Open | 01/31/20 | 94,667 |
| Centerville, OH | Open | 11/30/20 | 236,287 |
| Chesterfield Township, MI | Open | 12/31/20 | 146,250 |
| Birch Run, MI | Open | 12/31/24 | 608,508 |
| Berkley, MI | Open | 06/08/29 | 915,120 |
| Cascade Township, MI | Open | 06/08/29 | 839,844 |
| Avon, IN | Closed / re-leased | 06/30/29 | 1,368,744 |
| Greenwood, IN | Closed / re-leased | 06/30/29 | 1,416,960 |
| Canton, MI | Closed / re-leased | 06/30/30 | 1,880,022 |
| Total | | | \$ 7,579,193 |

4. PROPERTY AND EQUIPMENT, NET

Property and equipment are comprised of the following assets:

| | September 30, 2018 | December 31, 2017 |
|-------------------------------------|----------------------|----------------------|
| Equipment | \$ 29,944,512 | \$ 30,252,867 |
| Furniture and fixtures | 7,290,884 | 7,444,792 |
| Leasehold improvements | 63,886,601 | 64,936,413 |
| Restaurant construction in progress | 202,098 | 161,942 |
| Total | 101,324,095 | 102,796,014 |
| Less accumulated depreciation | (62,163,757) | (54,781,971) |
| Property and equipment, net | \$ 39,160,338 | \$ 48,014,043 |

Based on impairment indicators that existed at September 30, 2018, the Company performed an impairment analysis on certain long-lived assets subject to depreciation and recorded a fixed asset impairment of \$0.9 million related to one underperforming restaurant located in Missouri. The impairment charge was recorded to the extent that the carrying amount of the assets were not considered recoverable based on the estimated discounted cash flows and the underlying fair value of the assets, which was recorded in impairment and loss on asset disposals on the Consolidated Statements of Operations.

We are currently monitoring several restaurants with regard to the valuation of the property and equipment. As we periodically refine our estimated future operating results, changes in our estimates and assumptions may cause us to realize impairment charges in the future that could be material.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

5. INTANGIBLE ASSETS

Intangible assets are comprised of the following:

| | September 30, 2018 | December 31, 2017 |
|---|---------------------|---------------------|
| Amortized intangible assets | | |
| Franchise fees | \$ 1,305,642 | \$ 1,290,642 |
| Trademark | 2,500 | 2,500 |
| Non-compete | 76,560 | 76,560 |
| Favorable operating leases | 351,344 | 351,344 |
| Loan fees | — | 368,083 |
| Total | 1,736,046 | 2,089,129 |
| Less accumulated amortization | (772,675) | (907,269) |
| Total amortized intangible assets, net | 963,371 | 1,181,860 |
| Unamortized intangible assets | | |
| Liquor licenses | 1,256,327 | 1,256,327 |
| Total intangible assets, net | \$ 2,219,698 | \$ 2,438,187 |

Amortization expense was \$22,212 and \$21,067, \$63,822 and \$63,443 for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017, respectively. Amortization of favorable/unfavorable leases and loan fees are reflected as part of occupancy and interest expense, respectively.

The aggregate weighted-average amortization period for intangible assets is 8.0 years at September 30, 2018.

6. OTHER ACCRUED LIABILITIES

| | September 30, 2018 | December 31, 2017 |
|--|---------------------|---------------------|
| Sales tax payable | \$ 831,679 | \$ 906,410 |
| Accrued interest | 427,585 | 481,431 |
| Accrued royalty fees | 147,113 | 179,114 |
| Accrued property taxes | 620,676 | 69,970 |
| Accrued loyalty rewards | 777,524 | 439,106 |
| Other | 286,243 | 328,911 |
| Total other accrued liabilities | \$ 3,090,820 | \$ 2,404,942 |

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

7. LONG-TERM DEBT

Long-term debt consists of the following obligations:

| | September 30, 2018 | December 31, 2017 |
|---|----------------------|-----------------------|
| \$120.0 million term loan - the rate at September 30, 2018 and December 31, 2017 was 5.60% and 4.87%, respectively. | \$ 82,198,616 | \$ 89,698,616 |
| \$30.0 million development line of credit, converted \$18.2 million and \$3.1 million to a facility term loan in December 2016 and June 2018, respectively. The rate at September 30, 2018 and December 31, 2017 was 5.63% and 4.87%, respectively. | 18,553,976 | 16,682,853 |
| \$5.0 million revolving line of credit - the rate at September 30, 2018 and December 31, 2017 was 5.72% and 5.11%, respectively. | 5,000,000 | 5,000,000 |
| \$5.0 million development line of credit - the rate at December 31, 2017 was 5.00%. | — | 3,050,965 |
| Unamortized discount and debt issuance costs | (452,238) | (503,271) |
| Total debt | 105,300,354 | 113,929,163 |
| Less current portion | (11,513,280) | (11,440,433) |
| Long-term debt, net of current portion | \$ 93,787,074 | \$ 102,488,730 |

On June 29, 2015, the Company entered into a five year \$155.0 million senior secured credit facility with a syndicate of lenders led by Citizens Bank, N.A. (the "Senior Secured Credit Facility") with a senior lien on all the Company's personal property and fixtures. The Senior Secured Credit Facility consists of a \$120.0 million term loan (the "Term Loan"), a \$30.0 million development line of credit (the "DLOC") and a \$5.0 million revolving line of credit (the "RLOC").

On December 23, 2016, the Company amended the Senior Secured Credit Facility for purposes of, among other things, releasing the Bagger Dave's entities as borrowers and releasing all related liens on the Bagger Dave's assets. In addition, the amendment (a) converted the amounts then outstanding under the DLOC to a development facility term loan (the "DF Term Loan" and, together with the Term Loan, the "Term Loans"), (b) canceled \$6.8 million previously available under the DLOC, and (c) extended the maturity date on the remaining \$5.0 million under the DLOC to June 29, 2018. Upon the maturity of the DLOC on June 29, 2018, the amount outstanding under the DLOC was added to the existing DF Term Loan.

Payments of principal are based upon a 12 -year straight-line amortization schedule, with monthly principal payments of \$980,906 on the Term Loans, plus accrued interest. As of September 30, 2018, \$5.0 million was outstanding under the RLOC. The entire remaining outstanding principal and accrued interest on the Senior Secured Credit Facility is due and payable on the maturity date of June 29, 2020.

The interest rate for each of the loans, as selected by the borrower, is based upon either a LIBOR or base rate (generally Prime or Fed Funds) plus an applicable margin, which ranges from 2.25% to 3.5% for LIBOR loans and from 1.25% to 2.5% for base rate loans, depending on the lease adjusted leverage ratio as defined in the agreement.

Fees related to the Term Loans are recorded as debt discount and fees related to the DLOC and RLOC are capitalized as intangible assets. Debt issuance costs represent legal, consulting and financial costs associated with debt financing. As a result of the December 2016 Amendment, the Company incurred \$197,889 of debt issuance costs recorded as a part of debt discount. Debt discount related to term debt, net of accumulated amortization totaled \$452,238 and \$503,271 at September 30, 2018 and December 31, 2017, respectively. Debt discount and debt issuance cost are amortized over the life of the debt and are recorded in interest expense using the effective interest method.

For the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 interest expense was \$1.6 million and \$1.8 million, \$4.9 million and \$5.0 million, respectively.

The Senior Secured Credit Facility, as amended, contains various customary financial covenants generally based on the performance of the specific borrowing entity and other related entities. The more significant covenants consist of a minimum debt service coverage ratio and a maximum lease adjusted leverage ratio. On June 30, 2017 and February 28, 2018, the Company further amended the Senior Secured Credit Facility for purposes of revising the maximum lease adjusted leverage ratio and the minimum consolidated debt service coverage ratio and revising certain definitions impacting the calculation of the ratios. As of September 30, 2018, the Company is in compliance with the loan covenants.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

At September 30, 2018, the Company has three interest rate swap agreements to fix a portion of the interest rates on its variable rate debt. The swap agreements all qualify for hedge accounting. Under the swap agreements, the Company receives interest at the one-month LIBOR and pays a fixed rate. Since these swap agreements qualify for hedge accounting, the changes in fair value are recorded in other comprehensive income (loss), net of tax. The fair value of the derivative assets and liabilities are included in Other long-term assets and Other long-term liabilities on the Consolidated Balance Sheets, respectively. See Note 14 for additional information pertaining to interest rate swaps.

The following summarizes the fair values of derivative instruments designated as cash flow hedges which were outstanding:

| | | | September 30, 2018 | | |
|---------------------|------|---------------|----------------------|-------------------|------------------------|
| | | | Notional amounts | Derivative assets | Derivative liabilities |
| Interest rate swaps | Rate | Expires | | | |
| April 2012 | 1.4% | April 2019 | \$ 1,333,333 | \$ 3,980 | \$ — |
| January 2015 | 1.8% | December 2019 | 27,273,809 | 219,434 | — |
| August 2015 | 2.3% | June 2020 | 59,301,191 | 550,526 | — |
| Total | | | \$ 87,908,333 | \$ 773,940 | \$ — |

| | | | December 31, 2017 | | |
|---------------------|------|---------------|----------------------|-------------------|------------------------|
| | | | Notional amounts | Derivative assets | Derivative liabilities |
| Interest rate swaps | Rate | Expires | | | |
| April 2012 | 1.4% | April 2019 | \$ 3,047,619 | \$ 6,028 | \$ — |
| July 2013 | 1.4% | April 2018 | 2,833,333 | 778 | — |
| May 2014 | 1.5% | April 2018 | 7,142,857 | — | 408 |
| January 2015 | 1.8% | December 2019 | 21,690,476 | 25,953 | — |
| August 2015 | 2.3% | June 2020 | 60,412,798 | — | 461,455 |
| Total | | | \$ 95,127,083 | \$ 32,759 | \$ 461,863 |

8. SHARE-BASED COMPENSATION

Restricted share awards

On July 13, 2017, the Company's shareholders approved the Stock Incentive Plan of 2017. The Stock Incentive Plan of 2017 authorized a total of 2,500,000 shares for issuance as incentive awards.

For the nine-months ended September 30, 2018, restricted shares were issued to certain team members under the Stock Incentive Plan of 2017 at a weighted-average grant date fair value of \$1.29. For the nine-month period ended September 24, 2017, no restricted shares were issued. Based on the standard form of Stock Award Agreement, shares typically vest ratably over either a one or three year period, or on the third anniversary of the grant date, as determined by the Company's Compensation Committee. Upon vesting, the Company withholds shares to cover the minimum withholding requirement, unless the recipient opts out. Unrecognized share-based compensation expense of \$0.6 million at September 30, 2018 will be recognized over the remaining weighted-average vesting period of 1.7 years. The total grant date fair value of shares vested during the nine-month periods ended September 30, 2018 and September 24, 2017, was \$0.6 million and \$0.4 million, respectively. Under the Stock Incentive Plan of 2017, there were 1.8 million shares available for future awards at September 30, 2018.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

The following table presents the restricted stock transactions during the nine -month period ended September 30, 2018 :

| | Number of Restricted Stock Shares |
|-------------------------------------|--|
| Unvested, December 31, 2017 | 531,000 |
| Granted | 375,119 |
| Vested | (165,705) |
| Vested shares tax portion | (29,904) |
| Expired/Forfeited | (34,921) |
| Unvested, September 30, 2018 | 675,589 |

The following table presents the restricted stock transactions during the nine -month period ended September 24, 2017 :

| | Number of Restricted Stock Shares |
|-------------------------------------|--|
| Unvested, December 25, 2016 | 473,391 |
| Granted | 263,332 |
| Vested | (132,158) |
| Vested shares tax portion | (22,716) |
| Expired/Forfeited | (48,850) |
| Unvested, September 24, 2017 | 532,999 |

On July 30, 2010, prior to the adoption of the Stock Incentive Plan of 2011, DRH granted options for the purchase of 210,000 shares of common stock to the directors of the Company. These options are fully vested and had an original expiration date six years from the date of issuance. On July 28, 2016, the Stock Option Agreement of 2010 was amended to extend the expiration date of these options to July 31, 2019. The options can be exercised at a price of \$2.50 per share. At September 30, 2018 , 150,000 shares of authorized common stock are reserved for issuance to provide for the exercise of the remaining options. The intrinsic value of outstanding options was negligible as of both September 30, 2018 and September 24, 2017 .

Employee stock purchase plan

The Company reserved 250,000 shares of common stock for issuance under the Employee Stock Purchase Plan (“ESPP”). The ESPP is available to team members subject to employment eligibility requirements. Participants may purchase common stock at 85.0% of the lesser of the start or end price for the offering period. The plan has four offering periods, each start/end dates coincide with the fiscal quarter and are awarded on the last day of the offering period. During the nine-months ended September 30, 2018 and September 24, 2017 , the Company issued 47,078 and 24,519 shares, respectively. Under the ESPP, there were 100,110 shares available for future purchase at September 30, 2018 .

Share-based compensation

Share-based compensation of \$0.1 million and \$0.1 million , \$0.5 million and \$0.3 million and was recognized during the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively, as compensation costs in the Consolidated Statements of Operations and as additional paid-in capital on the Consolidated Statements of Stockholders' Equity (Deficit) to reflect the grant date fair value of shares vested.

The Company has authorized 10,000,000 shares of preferred stock at a par value of \$0.0001 . No preferred shares are issued or outstanding as of September 30, 2018 . Any preferences, rights, voting powers, restrictions, dividend limitations, qualifications, and terms and conditions of redemption shall be set forth and adopted by a Board of Directors' resolution prior to issuance of any series of preferred stock.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
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9. INCOME TAXES

The effective income tax benefit rate for continuing operations was (22.3)% and (63.2)% , and (26)% and (97)% for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively. The change in the effective income tax rate for the nine months ended September 30, 2018 compared with the nine months ended September 24, 2017 is primarily attributable to valuation allowance against the deferred tax asset and the reduction of the deferred tax liability caused by the change in certain tax attributes.

In accordance with the provisions of ASC 740, a valuation allowance was established as of December 31, 2017 , for the deferred tax assets of the Company, and remains in place as of September 30, 2018 . On a quarterly basis, the Company evaluates the recoverability of the deferred tax asset by reviewing current and projected company and restaurant industry trends, and the macro economic environment.

10. OPERATING LEASES

The Company's lease terms generally include renewal options, and frequently require us to pay a proportionate share of real estate taxes, insurance, common area maintenance, and other operating costs. Some restaurant leases provide for contingent rental payments based on sales thresholds.

Total rent expense was \$2.2 million and \$2.2 million , \$6.7 million and \$6.6 million for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively.

Scheduled future minimum lease payments for each of the five years and thereafter for non-cancelable operating leases for existing restaurants with initial or remaining lease terms in excess of one year at September 30, 2018 are summarized as follows:

| Year | Amount |
|-------------------|----------------------|
| Remainder of 2018 | \$ 2,182,708 |
| 2019 | 8,510,133 |
| 2020 | 8,440,957 |
| 2021 | 7,734,279 |
| 2022 | 6,963,903 |
| Thereafter | 35,285,924 |
| Total | \$ 69,117,904 |

DIVERSIFIED RESTAURANT HOLDINGS, INC.
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11. COMMITMENTS AND CONTINGENCIES

Refer to Note 3 for a discussion of lease guarantees provided by the Company.

Franchise Related

The Company is required to pay BWLD royalties (5.0% of net sales) and advertising fund contributions (3.00% - 3.15% of net sales). In addition, the Company is required to spend an additional 0.25% - 0.5% of regional net sales related to advertising cooperatives for certain metropolitan markets for the term of the individual franchise agreements. The Company incurred \$1.9 million and \$2.0 million , \$5.7 million and \$6.0 million in royalty expense for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively. Advertising fund contribution expenses were \$1.2 million and \$1.3 million , \$3.7 million and \$4.0 million for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively. Amounts are recorded in Other operating costs on the Consolidated Statement of Operations.

The Company is required by its various BWLD franchise agreements to modernize the restaurants during the term of the agreements. The individual agreements generally require improvements between the fifth and tenth year to meet the most current design model that BWLD has approved. The modernization costs for a restaurant have historically ranged from \$70,000 to \$1,300,000 depending on an individual restaurant's needs.

Legal Proceedings

The Company is subject to ordinary and routine legal proceedings, as well as demands, claims and threatened litigation, which arise in the ordinary course of its business. The ultimate outcome of any litigation is uncertain. We have insured and continue to insure against most of these types of claims. A judgment on any claim not covered by or in excess of our insurance coverage could materially adversely affect our financial condition or results of operations.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
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12. EARNINGS PER SHARE

The following is a reconciliation of basic and fully diluted earnings per common share for the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 :

| | Three months ended | |
|--|---------------------------|---------------------------|
| | September 30, 2018 | September 24, 2017 |
| Loss from continuing operations | \$ (1,761,372) | \$ (543,240) |
| Loss from discontinued operations | — | (15,154) |
| Net Loss | \$ (1,761,372) | \$ (558,394) |
| Weighted-average shares outstanding | 30,643,240 | 26,764,776 |
| Effect of dilutive securities | — | — |
| Weighted-average shares outstanding - assuming dilution | 30,643,240 | 26,764,776 |
| Earnings per common share from continuing operations | \$ (0.06) | \$ (0.02) |
| Earnings per common share from discontinued operations | — | — |
| Earnings per common share | \$ (0.06) | \$ (0.02) |
| Earnings per common share - assuming dilution - from continuing operations | (0.06) | (0.02) |
| Earnings per common share - assuming dilution - from discontinued operations | — | — |
| Earnings per common share - assuming dilution | \$ (0.06) | \$ (0.02) |
| | Nine Months Ended | |
| | September 30, 2018 | September 24, 2017 |
| Loss from continuing operations | \$ (2,709,753) | \$ (39,003) |
| Loss from discontinued operations | — | (97,361) |
| Net Loss | \$ (2,709,753) | \$ (136,364) |
| Weighted-average shares outstanding | 27,990,420 | 26,672,057 |
| Effect of dilutive securities | — | — |
| Weighted-average shares outstanding - assuming dilution | 27,990,420 | 26,672,057 |
| Earnings per common share from continuing operations | \$ (0.10) | \$ — |
| Earnings per common share from discontinued operations | — | — |
| Earnings per common share | \$ (0.10) | \$ — |
| Earnings per common share - assuming dilution - from continuing operations | (0.10) | — |
| Earnings per common share - assuming dilution - from discontinued operations | — | — |
| Earnings per common share - assuming dilution | \$ (0.10) | \$ — |

During the three and nine month periods ended September 30, 2018 and September 24, 2017 , 675,589 and 532,999 shares, respectively, of unvested restricted stock were excluded from the calculation of diluted earnings per share because such shares were anti-dilutive.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
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13. SUPPLEMENTAL CASH FLOWS INFORMATION

Other Cash Flows Information

Cash paid for interest was \$1.6 million and \$1.7 million , \$4.7 million and \$4.7 million during the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively.

Cash paid for income taxes was \$23,662 and \$0 , \$23,857 and \$2,819 during the three-month periods ended September 30, 2018 and September 24, 2017 and nine-month periods ended September 30, 2018 and September 24, 2017 , respectively.

Supplemental Schedule of Non-Cash Operating, Investing, and Financing Activities

Noncash investing activities for property and equipment not yet paid as of September 30, 2018 and September 24, 2017 , was \$0.1 million and \$0.0 million , respectively.

14. FAIR VALUE OF FINANCIAL INSTRUMENTS

The guidance for fair value measurements, FASB ASC 820, *Fair Value Measurements and Disclosures* , establishes the authoritative definition of fair value, sets out a framework for measuring fair value, and outlines the required disclosures regarding fair value measurements. Fair value is the price that would be received to sell 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 at the measurement date. We use a three-tier fair value hierarchy based upon observable and non-observable inputs as follows:

- Level 1 Quoted market prices in active markets for identical assets and liabilities;
- Level 2 Inputs, other than level 1 inputs, either directly or indirectly observable; and
- Level 3 Unobservable inputs developed using internal estimates and assumptions (there is little or no market data) which reflect those that market participants would use.

As of September 30, 2018 and December 31, 2017 , respectively, our financial instruments consisted of cash and cash equivalents, accounts receivable, accounts payable, interest rate swaps, lease guarantee liability, and debt. The fair value of cash and cash equivalents, accounts receivable, and accounts payable approximate carrying value, due to their short-term nature.

The fair value of our interest rate swaps is determined based on valuation models, which utilize quoted interest rate curves to calculate the forward value and then discount the forward values to the present period. The Company measures the fair value using broker quotes, which are generally based on observable market inputs including yield curves and the value associated with counterparty credit risk. Our interest rate swaps are classified as a Level 2 measurement as these securities are not actively traded in the market, but are observable based on transactions associated with bank loans with similar terms and maturities. See Note 7 for additional information pertaining to interest rates swaps.

The fair value of our lease guarantee liability was determined by calculating the present value of the difference between the estimated rate at which the Company and Bagger Dave's could borrow money in a duration similar to the underlying lease guarantees. Our lease guarantees are classified as a Level 2 measurement as there is no actively traded market for such instruments.

As of September 30, 2018 and December 31, 2017 , our total debt was approximately \$105.3 million and \$113.9 million , respectively, which approximated fair value because the applicable interest rates are adjusted frequently based on short-term market rates (Level 2).

There were no transfers between levels of the fair value hierarchy during the three and nine month period ended September 30, 2018 and the fiscal year ended December 31, 2017 .

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The following table presents the fair values for those assets and liabilities measured on a recurring basis as of September 30, 2018 :

FAIR VALUE MEASUREMENTS

| Description | Level 1 | Level 2 | Level 3 | Asset/(Liability) Total |
|---------------------------|-------------|-------------------|-------------|----------------------------|
| Interest rate swaps | \$ — | \$ 773,940 | \$ — | \$ 773,940 |
| Lease guarantee liability | — | (292,397) | — | (292,397) |
| Total | \$ — | \$ 481,543 | \$ — | \$ 481,543 |

The following table presents the fair values for those assets and liabilities measured on a recurring basis as of December 31, 2017 :

FAIR VALUE MEASUREMENTS

| Description | Level 1 | Level 2 | Level 3 | Asset/(Liability) Total |
|---------------------------|-------------|---------------------|-------------|----------------------------|
| Interest rate swaps | \$ — | \$ (429,104) | \$ — | \$ (429,104) |
| Lease guarantee liability | — | (303,006) | — | (303,006) |
| Total | \$ — | \$ (732,110) | \$ — | \$ (732,110) |

Non-financial assets and liabilities that are measured at fair value on a non-recurring basis

Our impairment analysis generally estimates long-lived asset fair values, including property, plant and equipment and leasehold improvements, using a discounted cash flow approach. The inputs used to determine fair value relate primarily to future assumptions regarding restaurant sales and profitability and our discount rate assumption. These inputs are categorized as Level 3 inputs. The inputs used represent management's assumptions about what information market participants would use in pricing the assets and are based upon the best information available at the balance sheet date. During Third Quarter 2018, we recorded an impairment charge of \$.9 million , for one underperforming restaurant.

DIVERSIFIED RESTAURANT HOLDINGS, INC.
NOTES TO INTERIM CONSOLIDATED FINANCIAL STATEMENTS

15. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes each component of Accumulated Other Comprehensive Income (Loss):

| | <u>Three Months Ended September 30, 2018</u> | <u>Three Months Ended September 24, 2017</u> |
|--|--|--|
| | <u>Interest Rate Swaps</u> | <u>Interest Rate Swaps</u> |
| Beginning balance | \$ 662,976 | \$ (1,088,255) |
| Gain recorded to other comprehensive income (loss) | 170,621 | 443,900 |
| Tax expense | (166,380) | (150,926) |
| Other comprehensive income | 4,241 | 292,974 |
| Accumulated other comprehensive income (loss) | \$ 667,217 | \$ (795,281) |

| | <u>Nine Months Ended September 30, 2018</u> | <u>Nine Months Ended September 24, 2017</u> |
|--|---|---|
| | <u>Interest Rate Swaps</u> | <u>Interest Rate Swaps</u> |
| Beginning balance | \$ (283,208) | \$ (934,222) |
| Gain recorded to other comprehensive loss | 1,203,044 | 210,517 |
| Tax expense | (252,619) | (71,576) |
| Other comprehensive income | 950,425 | 138,941 |
| Accumulated other comprehensive income (loss) | \$ 667,217 | \$ (795,281) |

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated interim financial statements and related notes included in Item 1 of Part 1 of this Quarterly Report and the audited consolidated financial statements and related notes and Management's Discussion and Analysis of Financial Condition and Results from Operations contained in our Form 10-K for the fiscal year ended December 31, 2017. Information included in this discussion and analysis includes commentary on company-owned restaurants, restaurant sales, and same store sales. Management believes such sales information is an important measure of our performance, and is useful in assessing the Buffalo Wild Wings® Grill & Bar ("BWW") concept. However, same store sales information does not represent sales in accordance with accounting principles generally accepted in the United States of America ("GAAP"), should not be considered in isolation or as a substitute for other measures of performance prepared in accordance with GAAP and may not be comparable to financial information as defined or used by other companies.

INFORMATION REGARDING FORWARD-LOOKING STATEMENTS

Some of the statements contained in this "Quarterly Report on Form 10-Q" may constitute "forward-looking statements" within the meaning of the Federal Private Securities Litigation Reform Act of 1995. These statements reflect the current views of our senior management team with respect to future events, including our financial performance, business and industry in general. Statements that include the words "expect," "intend," "plan," "believe," "project," "forecast," "estimate," "may," "should," "anticipate," and variations of such words and similar statements of a future or forward-looking nature are intended to identify such forward-looking statements. We intend for our forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we set forth this statement in order to comply with such safe harbor provisions.

Forward-looking statements involve known and unknown risks and uncertainties and are not assurances of future performance. Accordingly, actual results may differ materially from anticipated results due to a variety of factors, including the factors identified in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017. Important factors that could cause actual results to differ materially from our expectations include the following:

- the success of our existing and new restaurants;
- our ability to identify appropriate sites and to finance the development and expansion of our operations;
- changes in economic conditions;
- damage to our reputation or lack of acceptance of our brand in existing or new markets;
- economic and other trends and developments, including adverse weather conditions, in the local or regional areas in which our restaurants are located;
- the impact of negative economic factors, including the availability of credit, on our landlords and surrounding tenants;
- changes in food availability and costs;
- labor shortages and increases in our compensation costs, including those resulting from changes in government regulation;
- increased competition in the restaurant industry and the segments in which we compete;
- the impact of legislation and regulations regarding nutritional information, new information or attitudes regarding diet and health, or adverse opinions about the health of consuming our menu offerings;
- the impact of federal, state, and local beer, liquor, and food service regulations;
- the success of our and our franchisor's strategies and marketing programs;
- the impact of new restaurant openings, including the effect on our existing restaurants of opening new restaurants in the same markets;
- the loss of key members of our management team;
- inability or failure to effectively manage our growth, including without limitation, our need for liquidity and human capital;

- the impact of litigation;
- the adequacy of our insurance coverage and fluctuating insurance requirements and costs;
- the impact of our indebtedness on our ability to invest in the ongoing needs of our business;
- our ability to obtain debt or other financing on favorable terms, or at all;
- the impact of a potential asset impairment charge in the future;
- the impact of any security breaches of confidential guest information in connection with our electronic processing of credit/debit card transactions;
- our ability to protect our intellectual property;
- the impact of any failure of our information technology system or any breach of our network security;
- the impact of any materially adverse changes in our federal, state, and local taxes;
- the impact of any food-borne illness outbreak;
- our ability to maintain our relationship with our franchisor on economically favorable terms;
- the impact of future sales of our common stock in the public market, the exercise of stock options, and any additional capital raised by us through the sale of our common stock;
- the effect of changes in accounting principles applicable to us; and
- the impact on the Company's future results as a result of its guarantees of certain leases of Bagger Dave's Burger Tavern, Inc.

We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date they were made. Subsequent written and oral forward-looking statements attributable to us or to persons acting on our behalf are expressly qualified in their entirety by the cautionary statements set forth above and elsewhere in our reports filed with the Securities and Exchange Commission. We expressly disclaim any intent or obligation to update any forward-looking statements.

OVERVIEW

Diversified Restaurant Holdings, Inc. ("DRH" or the "Company") is a restaurant company operating a single concept, Buffalo Wild Wings[®] ("BWW"). DRH currently operates 64 BWW restaurants (20 in Michigan, 17 in Florida, 15 in Missouri, 7 in Illinois and 5 in Indiana), including the nation's largest BWW, based on square footage, in downtown Detroit, Michigan. As one of the largest franchisees of BWLD, we provide a unique guest experience in a casual and inviting environment. We are committed to providing value to our guests by offering generous portions of flavorful food in an upbeat and entertaining atmosphere. We believe BWW is a uniquely positioned restaurant brand, designed to maximize guest appeal, offering competitive price points and a family-friendly atmosphere, which we believe enables strong performance through economic cycles. We were incorporated in 2006 and are headquartered in the Detroit metropolitan area.

RESTAURANT OPENINGS

The following table outlines the restaurant unit information for each fiscal year from 2014 through 2018. The openings/closures and total restaurants open at the end of the year for 2018 are estimates.

| | 2018 | 2017 | 2016 | 2015 | 2014 |
|--|-----------|-----------|-----------|-----------|-----------|
| Restaurants open at the beginning of year | 65 | 64 | 62 | 42 | 36 |
| Openings/closures: | | | | | |
| New restaurant openings | — | 1 | 2 | 3 | 3 |
| Restaurant acquisitions | — | — | — | 18 | 3 |
| Restaurant closures | (1) | — | — | (1) | — |
| Total restaurants open at the end of the year | 64 | 65 | 64 | 62 | 42 |

RESULTS OF OPERATIONS

For the three-month periods ended September 30, 2018 (" Third Quarter 2018 ") and September 24, 2017 (" Third Quarter 2017 "), revenue was generated primarily from the operations of 65 restaurants. Quarterly operating results may fluctuate significantly as a result of a variety of factors, including the timing and number of new restaurant openings and related expenses, increases or decreases in same store sales, changes in commodity prices, general economic conditions, and seasonal fluctuations. As a result, our quarterly results of operations are not necessarily indicative of the results that may be achieved for any future period. Same store sales are defined as a restaurant's comparable sales in the first full month after the 18th month of operation. Changes in comparable restaurant sales reflect changes in sales for the comparable group of restaurants over a specified period of time. Our comparable restaurant base consisted of 62 restaurants at both September 30, 2018 and September 24, 2017 .

Results of Operations for the Three Months Ended September 30, 2018 and September 24, 2017

| | Three months ended | |
|--|--------------------|--------------------|
| | September 30, 2018 | September 24, 2017 |
| Total revenue | 100.0 % | 100.0 % |
| Operating expenses | | |
| Food, beverage, and packaging costs | 28.5 % | 29.5 % |
| Compensation costs | 27.4 % | 25.4 % |
| Occupancy costs | 7.8 % | 7.6 % |
| Other operating costs | 22.6 % | 22.3 % |
| General and administrative expenses | 5.3 % | 5.9 % |
| Pre-opening costs | — % | 0.2 % |
| Depreciation and amortization | 7.8 % | 8.3 % |
| Impairment and loss on asset disposal | 2.4 % | — % |
| Total operating expenses | 101.8 % | 99.2 % |
| Operating (loss) profit | (1.8)% | 0.8 % |
| Interest expense | (4.3)% | (4.6)% |
| Other income, net | 0.1 % | 0.1 % |
| Loss from continuing operations before income taxes | (6.0)% | (3.7)% |
| Income tax (expense) benefit of continuing operations | 1.3 % | 2.4 % |
| Loss from continuing operations | (4.7)% | (1.3)% |
| Loss from discontinued operations before income taxes | — % | (0.1)% |
| Income tax benefit of discontinued operations | — % | — % |
| Loss from discontinued operations | — % | (0.1)% |
| Net Loss | (4.7)% | (1.4)% |

Revenue for Third Quarter 2018 was \$37.5 million , a decrease of \$1.8 million , or 4.5% , compared to \$39.3 million of revenue generated during Third Quarter 2017 . The decrease in sales was the result of reduced traffic at our restaurants during the quarter, exacerbated by a large UFC fight that drove significant traffic in Third Quarter 2017. Third Quarter 2018 same-store sales decreased by 5.2%, or by 3.6% exclusive of the large UFC fight.

Food, beverage, and packaging costs decreased by \$0.9 million , or 7.6% , to \$10.7 million in Third Quarter 2018 from \$11.6 million in Third Quarter 2017 due to lower sales volumes. Food, beverage, and packaging costs as a percentage of revenue decreased to 28.5% in Third Quarter 2018 from 29.5% in Third Quarter 2017 primarily due to lower traditional chicken wing costs. Average cost per pound for traditional bone-in chicken wings, our most significant input cost, decreased to \$1.67 in Third Quarter 2018 compared with \$2.14 in Third Quarter 2017 .

Compensation costs increased by \$0.3 million , or 2.9% , to \$10.3 million in Third Quarter 2018 from \$10.0 million in Third Quarter 2017 due to higher average wages. Compensation costs as a percentage of sales increased to 27.4% in Third Quarter 2018 from 25.4% in Third Quarter 2017 as a result of lower average unit volumes compared to the same period last year and increases in average wages.

Occupancy costs were flat at \$2.9 million in Third Quarter 2018 compared to Third Quarter 2017 . Occupancy as a percentage of sales increased to 7.8% in Third Quarter 2018 compared with 7.6% in Third Quarter 2017 due to lower sales volumes compared to the same period last year.

Other operating costs decreased \$0.3 million , or 3.5% , to \$8.5 million in Third Quarter 2018 from \$8.8 million in Third Quarter 2017 due to cost saving initiatives as well as reduced royalty and advertising fund contributions as a result of lower sales volume, partially offset by higher delivery fees on increased sales via third party delivery. Other operating costs as a percentage of sales increased to 22.6% in Third Quarter 2018 from 22.3% in Third Quarter 2017 , due to lower sales volumes compared to the same period last year.

General and administrative expenses decreased by \$0.3 million , or 13.0% , to \$2.0 million in Third Quarter 2018 from \$2.3 million in Third Quarter 2017 . This decrease was primarily due to a decrease in corporate wages and other corporate expenses, partially offset by an increase in marketing expense. General and administrative expenses as a percentage of sales decreased to 5.3% in Third Quarter 2018 from 5.9% in Third Quarter 2017 .

Depreciation and amortization decreased by \$0.3 million , or 10.3% , to \$2.9 million in Third Quarter 2018 from \$3.2 million in Third Quarter 2017 . This decrease was primarily due to fixed asset disposals and fully depreciated assets. Depreciation and amortization as a percentage of sales decreased to 7.8% in Third Quarter 2018 from 8.3% in Third Quarter 2017 .

Impairment and loss on asset disposal increased by \$0.9 million to \$0.9 million in Third Quarter 2018 from \$0 million in Third Quarter 2017 . This increase was due to the impairment of fixed assets at one Missouri location in Third Quarter 2018. Impairment and loss on asset disposal as a percentage of sales increased to 2.4% in Third Quarter 2018 .

Results of Operations for the Nine Months Ended September 30, 2018 and September 24, 2017

| | Nine months ended | |
|--|--------------------|--------------------|
| | September 30, 2018 | September 24, 2017 |
| Total revenue | 100.0 % | 100.0 % |
| Operating expenses | | |
| Food, beverage, and packaging costs | 28.4 % | 29.6 % |
| Compensation costs | 26.8 % | 25.2 % |
| Occupancy costs | 7.6 % | 7.0 % |
| Other operating costs | 21.8 % | 21.2 % |
| General and administrative expenses | 5.6 % | 5.4 % |
| Pre-opening costs | — % | 0.3 % |
| Depreciation and amortization | 8.0 % | 8.2 % |
| Impairment and loss on asset disposal | 0.8 % | 0.2 % |
| Total operating expenses | 99.0 % | 97.1 % |
| Operating (loss) profit | 1.0 % | 2.9 % |
| Interest expense | (4.3)% | (4.1)% |
| Other income, net | 0.1 % | 0.1 % |
| Loss from continuing operations before income taxes | (3.2)% | (1.1)% |
| Income tax benefit of continuing operations | 0.8 % | 1.2 % |
| Income (loss) from continuing operations | (2.4)% | 0.1 % |
| Loss from discontinued operations before income taxes | — % | (0.1)% |
| Income tax benefit of discontinued operations | — % | — % |
| Loss from discontinued operations | — % | (0.1)% |
| Net loss | (2.4)% | — % |

Revenue for the nine months ended September 30, 2018 ("Year to Date 2018 ") was \$114.1 million , a decrease of \$9.5 million , or 7.7% , compared to \$123.5 million of revenue generated during the nine months ended September 24, 2017 ("Year to Date 2017 "). The decrease was driven by lower traffic in our restaurants in Year to Date 2018, including traffic from a large UFC fight occurring in Third Quarter 2017, partially offset by sales from a new restaurant opened in June of 2017.

Food, beverage, and packaging costs decreased by \$4.1 million , or 11.3% , to \$32.4 million in Year to Date 2018 from \$36.5 million in Year to Date 2017 due to lower volumes. Food, beverage, and packaging costs as a percentage of revenue decreased to 28.4% in Year to Date 2018 from 29.6% in Year to Date 2017 primarily due to lower traditional chicken wing costs. Average cost per pound for traditional bone-in chicken wings, our most significant input cost, decreased to \$1.74 in Year to Date 2018 compared with \$2.06 in Year to Date 2017 .

Compensation costs decreased by \$0.5 million , or 1.7% , to \$30.6 million in Year to Date 2018 from \$31.1 million in Year to Date 2017 due to lower hourly wages on lower average unit volumes partially offset by higher average wages. Compensation costs as a percentage of sales increased to 26.8% in Year to Date 2018 from 25.2% in Year to Date 2017 due to lower average unit volumes coupled with higher average wages.

Occupancy costs were flat at \$8.7 million in Year to Date 2018 compared to Year to Date 2017 . Occupancy as a percentage of sales increased to 7.6% in Year to Date 2018 compared with 7.0% in Year to Date 2017 as a result of lower sales volumes.

Other operating costs decreased \$1.4 million , or 5.2% , to \$24.8 million in Year to Date 2018 from \$26.2 million in Year to Date 2017 due to cost saving initiatives as well as reduced royalty and advertising fund contributions as a result of lower sales volume. Other operating costs as a percentage of sales increased to 21.8% in Year to Date 2018 from 21.2% in Year to Date 2017 , primarily due to lower average unit volumes.

General and administrative expenses decreased \$0.3 million , or 5.4% to \$6.4 million in Year to Date 2018 from \$6.7 million in Year to Date 2017 . Lower wage and other corporate expenses in Year to Date 2018 were offset by higher marketing expense. General and administrative expenses as a percentage of sales increased to 5.6% in Year to Date 2018 from 5.4% in Year to Date 2017 as a result of lower sales volumes.

Pre-opening costs decreased \$0.4 million , or 100.0% , to \$0 in Year to Date 2018 from \$0.4 million in Year to Date 2017 . We haven't opened any new restaurants in 2018 and opened one new restaurants in the Second Quarter 2017 . Pre-opening costs as a percentage of sales decreased to 0.0% in Year to Date 2018 from 0.3% in Year to Date 2017 .

Depreciation and amortization decreased by \$1.0 million , or 9.6% , to \$9.2 million in Year to Date 2018 from \$10.1 million in Year to Date 2017 . This decrease was primarily due to fixed asset disposals and fully depreciated assets. Depreciation and amortization as a percentage of sales decreased to 8.0% in Year to Date 2018 from 8.2% in Year to Date 2017 .

Impairment and loss on asset disposal increased by \$0.6 million , or 207.7% to \$0.9 million in Year to Date 2018 from \$0.3 million in Year to Date 2017 . This increase was primarily due to the impairment of fixed assets at one Missouri location in Third Quarter 2018. Impairment and loss on asset disposal as a percentage of sales increased to 0.8% in Year to Date 2018 from 0.2% in Year to Date 2017 .

INTEREST AND TAXES

Interest expense decreased \$0.2 million to \$1.6 million or 11.7% in the Third Quarter 2018 from \$1.8 million during the Third Quarter 2017 . Interest expense was \$4.9 million and \$5.0 million in Year to Date 2018 and in Year to Date 2017 , respectively.

For Third Quarter 2018 , DRH had an income tax benefit of \$0.5 million compared to Third Quarter 2017 income tax benefit of \$0.9 million . For Year to Date 2018 , DRH had an income tax benefit of \$1.0 million compared to Year to Date 2017 income tax benefit of \$1.5 million . The decrease in the income tax benefit is primarily attributable to valuation allowance against the deferred tax asset and the reduction of the deferred tax liability caused by the change in certain tax attributes.

LIQUIDITY AND CAPITAL RESOURCES

On June 29, 2015, the Company entered into a five-year \$155.0 million senior secured credit facility with a syndicate of lenders led by Citizens Bank, N.A. (the "Senior Secured Credit Facility") with a senior lien on all the Company's personal property and fixtures. The Senior Secured Credit Facility consists of a \$120.0 million term loan (the "Term Loan"), a \$30.0 million development line of credit (the "DLOC") and a \$5.0 million revolving line of credit (the "RLOC").

On December 23, 2016, the Company amended the Senior Secured Credit Facility for purposes of, among other things, releasing the Bagger Dave's entities as borrowers and releasing all related liens on the Bagger Dave's assets. In addition, the amendment (a) converted the amounts then outstanding under the DLOC to a development facility term loan (the "DF Term Loan" and, together with the Term Loan, the "Term Loans"), (b) canceled \$6.8 million previously available under the DLOC, and (c) extended the maturity date on the remaining \$5.0 million under the DLOC to June 29, 2018. Upon the maturity of the DLOC on June 29, 2018, the amount outstanding under the DLOC was added to the existing DF Term Loan.

Payments of principal are based upon a 12-year straight-line amortization schedule, with monthly principal payments of \$980,906 on the Term Loans, plus accrued interest. As of September 30, 2018 , \$5.0 million was outstanding under the RLOC. The entire remaining outstanding principal and accrued interest on the Senior Secured Credit Facility is due and payable on the maturity date of June 29, 2020.

The interest rate for each of the loans, as selected by the borrower, is based upon either a LIBOR or base rate (generally Prime or Fed Funds) plus an applicable margin, which ranges from 2.25% to 3.5% for LIBOR loans and from 1.25% to 2.5% for base rate loans, depending on the lease adjusted leverage ratio as defined in the agreement.

The Senior Secured Credit Facility, as amended, contains various customary financial covenants generally based on the performance of the Company. The financial covenants consist of a quarterly minimum required debt service coverage ratio (the "DSCR") and a maximum permitted lease adjusted leverage ratio (the "LALR"). Pursuant to an amendment dated February 28, 2018, the Company amended the Senior Secured Credit Facility which revised the minimum required DSCR and the maximum permitted LALR and revised certain definitions impacting the calculation of the ratios. As of September 30, 2018, the Company was in compliance with the loan covenants.

On July 24, 2018 the Company completed an underwritten registered public offering of 6 million shares of common stock at a public offering price of \$1.00 per share, which included 700,000 shares offered by a certain selling stockholder, for total Company gross proceeds of \$5.3 million. The net proceeds from the Offering were approximately \$4.6 million, after deducting the underwriting discounts and commissions and offering expenses payable by us. We intend to use the net proceeds from the offering for working capital and general corporate purposes, which may include repayment of debt.

The offering was made pursuant to a shelf registration statement on Form S-3 (File No. 333-225457) that was filed with the SEC and became effective on July 5, 2018. A prospectus supplement and accompanying prospectus relating to and describing the terms of the offering were filed with the SEC on July 23, 2018.

We believe that our current cash balance, in addition to our cash flow from operations, will be sufficient to fund our present operations and meet our commitments on our existing debt for the next twelve months. However, if our forecasts are wrong or working capital needs arise that require additional financing, we believe that our current leverage level and business performance would result in rates and terms for additional debt financing that would be unattractive, if additional financing is available at all. Therefore, if necessary, we may issue additional shares of common or preferred stock to raise funds.

Outside of funding our current operations and servicing our existing debt, our capital requirements are primarily dependent upon our restaurant remodel requirements and the pace of our new restaurant growth plan.

We believe that reinvesting in existing restaurants is an important factor and necessary to maintain the overall positive dining experience for our guests and, as a result, we have historically invested heavily in refreshes and upgrades. Depending on the age of the existing restaurants, upgrades have ranged from \$50,000 (for minor interior refreshes or audio/video upgrades) to \$1.3 million (for a full extensive remodel of the restaurant). We currently target remodels of no more than \$0.5 million to upgrade a typical BWW restaurant to the Stadia design. We've remodeled or built 27 of our restaurants in the Stadia design, and our current plan is to fully remodel the remaining 38 BWW restaurants to the latest BWLD design by no later than 2022. However, after the change in ownership of our franchisor, remodel activity is currently on hold while new management completes a full review of specifications.

We do not currently plan to complete any new restaurant development or any significant facility upgrades until our liquidity and capital resources improve.

Cash flow from continuing operations for the nine months ended September 30, 2018 was \$8.1 million compared with \$9.8 million for the nine months ended September 24, 2017. Net cash provided by operating activities consisted primarily of net earnings adjusted for non-cash expenses.

After the Spin-Off of Bagger Dave's, the Company retained certain tax benefits (net operating loss and tax credit carryforwards) and, since the Spin-Off, the Company has generated additional tax benefits which, together, will offset pre-tax income totaling over \$75 million at current estimated tax rates. We do not expect to incur significant federal and/or state income tax liabilities until our tax benefits have been fully utilized.

Mandatory Upgrades

In fiscal year 2018, we do not currently expect to complete, nor are we required by BWLD to complete, any remodels.

Discretionary Upgrades and Relocations

In fiscal year 2018, the Company plans to invest additional capital to provide for minor facility upgrades and general maintenance-type investments in our restaurants, all of which we expect to fund with cash from operations. We do not expect to develop any new restaurants or complete any remodels of our existing restaurants. In fiscal year 2018, we do not have any planned relocations. The decision to relocate is typically driven by timing of our current lease agreements and the availability of real estate that we deem to be a better long-term investment. Relocations are funded by a combination of cash from operations and borrowing from our credit facility.

Impact of Inflation

Our profitability is dependent, among other things, on our ability to anticipate and react to changes in the costs of key operating resources, including food and other raw materials, labor, energy, and other supplies and services. Substantial increases in costs and expenses could impact our operating results to the extent that such increases cannot be passed along to our restaurant guests. The impact of inflation on food, labor, energy and occupancy costs can significantly affect the profitability of our restaurant operations.

All of our non-management restaurant team members are paid hourly rates related to the federal minimum wage. Certain operating costs, such as taxes, insurance, and other outside services continue to increase with the general level of inflation or higher and may also be subject to other cost and supply fluctuations outside of our control.

While we have been able to partially offset inflation and other changes in the costs of key operating resources by gradually increasing prices for our menu items, more efficient purchasing practices, productivity improvements, and greater economies of scale, there can be no assurance that we will be able to continue to do so in the future. From time to time, competitive conditions could limit our menu pricing flexibility. In addition, macroeconomic conditions could make additional menu price increases imprudent. There can be no assurance that all future cost increases can be offset by increased menu prices or that increased menu prices will be fully absorbed by our restaurant guests without any resulting changes in their visit frequencies or purchasing patterns. There can be no assurance that we will continue to generate increases in comparable restaurant sales in amounts sufficient to offset inflationary or other cost pressures.

OFF-BALANCE SHEET ARRANGEMENTS

After the Spin-Off, the Company remains liable for guarantees of certain Bagger Dave's leases. These guarantees cover 12 separate leases, several of which relate to restaurants previously closed and are being operated by a new tenant under either a sub-lease or a new lease.

The Company has determined that its maximum exposure resulting from the lease guarantees includes approximately \$7.6 million of future minimum lease payments plus potential additional payments to satisfy maintenance, property tax and insurance requirements under the leases as of September 30, 2018. The terms and conditions of the guarantees vary, and each guarantee has an expiration date which may or may not correspond with the end of the underlying lease term. These expiration dates range from less than 2 months to 12 years as of September 30, 2018. In the event that the Company is required to perform under any of its lease guarantees, we do not believe a liability to the Company would be material because it would first seek to minimize its exposure by finding a suitable tenant to sub-lease the space. In many cases, we expect that a replacement tenant would be found and the lessor would agree to release the Company from its future guarantee obligation.

In conjunction with the Spin-Off, DRH entered into a transition services agreement (the "TSA") with Bagger Dave's pursuant to which DRH provided certain information technology and human resources support, limited accounting support, and other minor administrative functions at no charge. The TSA was intended to assist the discontinued component in efficiently and seamlessly transitioning to stand on its own. Certain provisions of the TSA terminated in December 2017 and the First Amendment to TSA (the "Amended TSA") was entered into effective January 1, 2018. Under the Amended TSA, DRH will provide ongoing administrative support to Bagger in certain areas, including information technology, human resources and real estate, in exchange for a fee based on a rate-per-hour of service.

Impact of New Accounting Standards

See Note 1, "Nature of Business and Basis of Presentation" included in Part 1, Item 1, "Notes to Interim Consolidated Financial Statements," of this Quarterly Report.

CRITICAL ACCOUNTING ESTIMATES

We prepare our consolidated financial statements in conformity with GAAP. The preparation of these financial statements requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Our critical accounting policies have not changed materially from those previously reported in our Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

Item 3. Quantitative and Qualitative Disclosure About Market Risks

Not applicable for smaller reporting companies.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

We are required to maintain disclosure controls and procedures designed to ensure that material information related to us, including our consolidated subsidiaries, is recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission rules and forms. Management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all error and fraud. Any control system, no matter how well designed and operated, is based upon certain assumptions and can provide only reasonable, not absolute, assurance that its objectives will be met. Further, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the Company have been detected.

Conclusion regarding the effectiveness of disclosure controls and procedures

As of September 30, 2018, an evaluation was performed under the supervision of and with the participation of our management, including our principal executive and principal financial officers, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including our principal executive and principal financial officers, concluded that our disclosure controls and procedures were effective as of September 30, 2018.

(b) Changes in internal control over financial reporting.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2018 that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

Our process for evaluating controls and procedures is continuous and encompasses constant improvement of the design and effectiveness of established controls and procedures and the remediation of any deficiencies that may be identified during this process.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We are occasionally a defendant in litigation arising in the ordinary course of our business, including claims arising from personal injuries, contract claims, dram shop claims, employment-related claims, and claims from guests or team members alleging injury, illness, or other food quality, health, or operational concerns. To date, none of these types of litigation, most of which are entirely or predominantly covered by insurance, has had a material effect on our financial condition or results of operations. We have insured and continue to insure against most of these types of claims. A judgment on any claim not covered by or in excess of our insurance coverage could materially adversely affect our financial condition or results of operations. As of the date of this Quarterly Report, we are not a party to any material pending legal proceedings and are not aware of any claims that could have a materially adverse effect on our financial position, results of operations or cash flows.

Item 1A. Risk Factors

There have been no material changes in the Company's risk factors as disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017.

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

Our purchases of our common stock during the Third Quarter 2018 were as follows:

| <u>Fiscal Period</u> | <u>Total Number of Shares (or Units) Purchased</u> | <u>Average Price Paid Per Share (or Unit)</u> | <u>Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs ⁽¹⁾</u> | <u>Maximum Number (or Approximate Dollar Amount) of Shares (or Units) that May Yet Be Purchased under the Plans or Programs ⁽¹⁾</u> |
|---------------------------|--|---|---|--|
| July 2 to July 29 | 7,112 | \$ 0.98 | — | — |
| July 30 to August 26 | 3,439 | \$ 1.01 | — | — |
| August 27 to September 30 | — | \$ — | — | — |

⁽¹⁾ During Third Quarter 2018, the Company withheld these shares from restricted stock grants to satisfy the individual's tax withholding obligations upon the vesting of the restricted stock grants.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

| Exhibit No. | Exhibit Description |
|-------------|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Rule 13a-14(a). |
| 31.2 | Certification Chief Financial Officer pursuant to Rule 13a-14(a). |
| 32.1 | Certification Chief Executive Officer pursuant to 18 U.S.C. Section 1350. |
| 32.2 | Certification Chief Financial Officer pursuant to 18 U.S.C. Section 1350. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Document |
| 101.DEF | XBRL Taxonomy Extension Definition Document |
| 101.LAB | XBRL Taxonomy Extension Label Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Document |

SIGNATURES

In accordance with Section 13 or 15(d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, there unto duly authorized.

DIVERSIFIED RESTAURANT HOLDINGS, INC.

Dated: November 7, 2018

By: /s/ David G. Burke

David G. Burke
President and Chief Executive
Officer (Principal Executive Officer)

By: /s/ Phyllis A. Knight

Phyllis A. Knight
Chief Financial Officer and Treasurer
(Principal Financial and Accounting Officer)

Exhibit 31.1

RULE 13a-14(a) CERTIFICATION OF CHIEF EXECUTIVE OFFICER

I, David G. Burke, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2018 of Diversified Restaurant Holdings, Inc. (the "Company");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13-a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonable likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 7, 2018

DIVERSIFIED RESTAURANT HOLDINGS, INC.

By: /s/ David G. Burke

David G. Burke
President and
Chief Executive Officer
(Principal Executive Officer)

Exhibit 31.2

RULE 13a-14(a) CERTIFICATION OF CHIEF FINANCIAL OFFICER

I, Phyllis A. Knight, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2018 of Diversified Restaurant Holdings, Inc. (the "Company");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13-a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonable likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: November 7, 2018

DIVERSIFIED RESTAURANT HOLDINGS, INC.

By: /s/ Phyllis A. Knight
Phyllis A. Knight
Treasurer and Chief Financial Officer
(Principal Financial Officer)

Exhibit 32.1

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Quarterly Report on Form 10-Q ("Quarterly Report") of Diversified Restaurant Holdings, Inc. (the "Company") for the fiscal quarter ended September 30, 2018, I, David G. Burke, President and Chief Executive Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

1. The Quarterly Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 7, 2018

DIVERSIFIED RESTAURANT HOLDINGS, INC.

By: /s/ David G. Burke

David G. Burke
President and
Chief Executive Officer
(Principal Executive Officer)

Exhibit 32.2

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the accompanying Quarterly Report on Form 10-Q ("Quarterly Report") of Diversified Restaurant Holdings, Inc. (the "Company") for the fiscal quarter ended September 30, 2018, I, Phyllis A. Knight, Treasurer and Chief Financial Officer of the Company, hereby certify pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, to the best of my knowledge and belief, that:

1. The Quarterly Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Quarterly Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: November 7, 2018

DIVERSIFIED RESTAURANT HOLDINGS, INC.

By: /s/ Phyllis A. Knight

Phyllis A. Knight
Treasurer and Chief Financial Officer
(Principal Financial Officer)