MORGANS FOODS INC
Form 10-Q
September 30, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-Q

(Mark One)

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

For the quarterly period ended August 16, 2009

or

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

For the transition period from __________ to __________

Commission File Number 1-08395

Morgan s Foods, Inc.

(Exact name of registrant as specified in its charter)

Ohio	34-0562210
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
4829 Galaxy Parkway, Suite S, Cleveland, Ohio	44128
(Address of principal executive offices)	(Zip Code)

(216) 359-9000

(Registrant s telephone number, including area code)

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

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

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

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o	Smaller reporting company þ
		(Do not check if a smaller reporting company)	

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

As of September 28, 2009, the issuer had 2,934,995 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements

MORGAN S FOODS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Quarter Ended	
	August 16, 2009	**August 17, 2008**
Revenues	$23,202,000	$23,049,000
Cost of sales:		
Food, paper and beverage	7,356,000	7,506,000
Labor and benefits	6,405,000	6,557,000
Restaurant operating expenses	6,004,000	6,041,000
Depreciation and amortization	711,000	791,000
General and administrative expenses	1,437,000	1,364,000
Loss (gain) on restaurant assets	15,000	(9,000)
Operating income	1,274,000	799,000
Interest expense:		
Prepayment and deferred financing costs	82,000	428,000
Bank debt and notes payable	591,000	734,000
Capital leases	25,000	27,000
Other income and expense, net	(43,000)	(79,000)
Income (loss) before income taxes	619,000	(311,000)
Provision for income taxes	299,000	330,000
Net income (loss)	$ 320,000	$ (641,000)
Basic net income (loss) per common share:	$ 0.11	$ (0.22)
Diluted net income (loss) per common share:	$ 0.11	$ (0.22)
Basic weighted average number of shares outstanding	2,934,995	2,934,995
Diluted weighted average number of shares outstanding	2,990,361	2,944,450

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Twenty-four Weeks Ended	
	August 16, 2009	**August 17, 2008**
Revenues	$46,133,000	$44,802,000
Cost of sales:		
Food, paper and beverage	14,766,000	14,470,000
Labor and benefits	12,833,000	12,795,000
Restaurant operating expenses	11,880,000	11,528,000
Depreciation and amortization	1,428,000	1,564,000
General and administrative expenses	2,846,000	2,714,000
Loss (gain) on restaurant assets	21,000	(4,000)
Operating income	2,359,000	1,735,000
Interest expense:		
Prepayment and deferred financing costs	82,000	428,000
Bank debt and notes payable	1,216,000	1,558,000
Capital leases	50,000	53,000
Other income and expense, net	(87,000)	(169,000)
Income (loss) before income taxes	1,098,000	(135,000)
Provision for income taxes	424,000	412,000
Net income (loss)	$ 674,000	$ (547,000)
Basic net income (loss) per common share:	$ 0.23	$ (0.19)
Diluted net income (loss) per common share:	$ 0.23	$ (0.19)
Basic weighted average number of shares outstanding	2,934,995	2,934,995
Diluted weighted average number of shares outstanding	2,976,733	2,951,173

See notes to these consolidated financial statements

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MORGAN S FOODS, INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	August 16, 2009	March 1, 2009
ASSETS		
Current assets:		
Cash and equivalents	$ 6,875,000	$ 5,257,000
Receivables	461,000	806,000
Inventories	710,000	731,000
Prepaid expenses	322,000	624,000
Assets held for sale	678,000	828,000
	9,046,000	8,246,000
Property and equipment:		
Land	9,558,000	9,558,000
Buildings and improvements	20,886,000	20,692,000
Property under capital leases	1,314,000	1,314,000
Leasehold improvements	10,444,000	10,615,000
Equipment, furniture and fixtures	20,115,000	19,891,000
Construction in progress	372,000	316,000
	62,689,000	62,386,000
Less accumulated depreciation and amortization	30,708,000	29,827,000
	31,981,000	32,559,000
Other assets	614,000	676,000
Franchise agreements, net	1,198,000	1,260,000
Deferred tax asset	398,000	594,000
Goodwill	9,227,000	9,227,000
	$ 52,464,000	$ 52,562,000
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Long-term debt, current	$ 3,066,000	$ 16,475,000
Current maturities of capital lease obligations	41,000	39,000
Accounts payable	4,105,000	3,909,000
Accrued liabilities	4,408,000	3,934,000
	11,620,000	24,357,000
Long-term debt	31,363,000	19,738,000
Long-term capital lease obligations	1,085,000	1,105,000
Other long-term liabilities	4,152,000	4,061,000
Deferred tax liabilities	2,343,000	2,130,000

SHAREHOLDERS EQUITY		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		
Common stock, no par value		
Authorized shares - 25,000,000		
Issued shares - 2,969,405	30,000	30,000
Treasury shares - 34,410	(81,000)	(81,000)
Capital in excess of stated value	29,488,000	29,432,000
Accumulated deficit	(27,536,000)	(28,210,000)
Total shareholders equity	1,901,000	1,171,000
	$ 52,464,000	$ 52,562,000

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.
CONSOLIDATED STATEMENT OF SHAREHOLDERS EQUITY
(UNAUDITED)

	Common Shares		Treasury Shares		Capital in excess of stated value	Accumulated Deficit	Total Shareholders Equity
	Shares	Amount	Shares	Amount			
Balance March 1, 2009	2,969,405	$30,000	(34,410)	$(81,000)	$29,432,000	$(28,210,000)	$1,171,000
Net income						674,000	674,000
Stock compensation expense					56,000		56,000
Balance May 24, 2009	2,969,405	$30,000	(34,410)	$(81,000)	$29,488,000	$(27,536,000)	$1,901,000

See notes to these consolidated financial statements.

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MORGAN S FOODS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Twenty-four Weeks Ended	
	August 16, 2009	August 17, 2008
Cash flows from operating activities:		
Net income (loss)	$ 674,000	$ (547,000)
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	1,428,000	1,564,000
Amortization of deferred financing costs	57,000	59,000
Amortization of supply agreement advances	(563,000)	(473,000)
Funding from supply agreements		38,000
Deferred income taxes	409,000	472,000
Stock compensation expense	56,000	
Disposal of restaurant assets	21,000	(4,000)
Changes in assets and liabilities:		
Receivables	395,000	18,000
Inventories	21,000	(32,000)
Prepaid expenses	302,000	297,000
Other assets	5,000	
Accounts payable	196,000	(840,000)
Accrued liabilities	1,106,000	(819,000)
Net cash provided by (used in) operating activities	4,107,000	(267,000)
Cash flows from investing activities:		
Proceeds from sale of restaurant	119,000	
Capital expenditures	(802,000)	(2,956,000)
Proceeds from sale/leasebacks		1,972,000
Purchase of license and other investments	(4,000)	
Net cash used in investing activities	(687,000)	(984,000)
Cash flows from financing activities:		
Proceeds from long-term borrowings		3,000,000
Principal payments on long-term debt	(1,478,000)	(1,532,000)
Principal payments on capital lease obligations	(18,000)	(13,000)
Bank debt repayment in advance	(306,000)	(2,451,000)
Deferred gain on sale/leaseback transactions		3,216,000
Net cash provided by (used in) financing activities	(1,802,000)	2,220,000
Net change in cash and equivalents	1,618,000	969,000
Cash and equivalents, beginning balance	5,257,000	6,428,000
Cash and equivalents, ending balance	$ 6,875,000	$ 7,397,000

Interest paid was $1,311,000 and $1,697,000 in the first 24 weeks of fiscal 2010 and 2009 respectively
Cash payments for income taxes were $3,000 and $34,000 in the first 24 weeks of fiscal 2010 and 2009 respectively

See notes to these consolidated financial statements.

MORGAN S FOODS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements of Morgan s Foods, Inc. (the Company) have been prepared without audit. In the opinion of Company management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company s annual report on Form 10-K for the year ended March 1, 2009. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the twenty-four weeks ended August 16, 2009 are not necessarily indicative of the results to be expected for the full year. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company s Form 10-K for the fiscal year ended March 1, 2009. Management has considered events occurring through September 30, 2009 for possible disclosure as subsequent events.

The Company s debt is reported at historical cost, based upon stated interest rates which represented market rates at the time of borrowing. Due to subsequent declines in credit quality throughout the restaurant industry resulting from weak and volatile operating performance and related declines in restaurant values, the market for fixed rate mortgage debt for restaurant financing is currently extremely limited. The Company s debt is not publicly traded and there are few lenders or financing transactions for similar debt in the marketplace at this time. Consequently, management has not been able to identify a market for fixed rate restaurant mortgage debt with a similar risk profile, and has concluded that it is not practicable to estimate the fair value of the Company s debt as of August 16, 2009.

NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS

Effective July 1, 2009, the FASB (Financial Accounting Standards Board) Accounting Standards Codification (ASC) (Topic 105, Generally Accepted Accounting Principles), became the single source for authoritative nongovernmental U.S. generally accepted accounting principles. During fiscal 2010, four new accounting standards became effective. These new standards are included in Topic 820 Fair Value Measurements and Disclosures as it relates to non-financial assets and liabilities, Topic 805 Disclosures About Derivative Investments and Hedging Activities , Topic 815 Business Combinations and Topic 855 Subsequent Events of the FASB ASC. The Company has determined that the changes to the accounting standards in fiscal 2010 do not have a material effect on the Company s financial position or results of operations.

NOTE 3 NET INCOME PER COMMON SHARE

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share is based on the combined weighted average number of shares outstanding, which includes the assumed exercise, or conversion of options. In computing diluted net income (loss) per common share, the Company has utilized the treasury stock method. The following table reconciles the difference between basic and diluted earnings per common share:

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	For the Quarter ended August 16, 2009			For the Quarter ended August 17, 2008		
	Net income (Numerator)	Shares (Denominator)	Per Share Amount	Net loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 320,000	2,934,995	$ 0.11	$ (641,000)	2,934,995	$ (0.22)
Effect of Dilutive Securities						
Weighted Average Stock Options		55,366			9,455	
Diluted EPS						
Income available to common shareholders	$ 320,000	2,990,361	$ 0.11	$ (641,000)	2,944,450	$ (0.22)

	Twenty-four weeks ended August 16, 2009			Twenty-four weeks ended August 17, 2008		
	Net income (Numerator)	Shares (Denominator)	Per Share Amount	Net loss (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$ 674,000	2,934,995	$ 0.23	$ (547,000)	2,934,995	$ (0.19)
Effect of Dilutive Securities						
Weighted Average Stock Options		41,738			16,178	
Diluted EPS						
Income available to common shareholders	$ 674,000	2,976,733	$ 0.23	$ (547,000)	2,951,173	$ (0.19)

Options to purchase 157,500 common shares were outstanding during the 2010 fiscal year but were included in the computation only for the time during which their exercise price was greater than the average market price of the common shares. Options for 7,500 shares, exercisable at $3.00 per share expire on January 7, 2010 and options for 150,000 shares, exercisable at $1.50 per share expire on November 5, 2018.

NOTE 4 DEBT

The Company s debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1 regarding all of the Company s mortgage loans and the maintenance of individual restaurant fixed charge coverage ratios of between 1.2 and 1.5 to 1 on certain of the Company s mortgage loans. A portion of the Company s debt also contains a funded debt to EBITDAR (earnings before interest, taxes, depreciation, amortization and rent) requirement of 5.5. Fixed charge coverage ratios are calculated by dividing the cash flow before rent and debt service for the previous 12 months by the debt service and rent due in the coming 12 months. In the calculation of funded debt to EBITDAR, funded debt is the next twelve month operating lease obligation times eight plus the debt balance at the measurement date. The funded debt is then divided by the prior twelve month EBITDAR to obtain the calculated ratio. The consolidated and individual ratios are all computed quarterly. As of May 24, 2009, the Company entered into a loan modification agreement covering a portion of its debt which reduced the consolidated fixed charge coverage ratio to 1.15 to 1 from 1.20 to 1 and increased the funded debt to EBITDAR ratio to 6.15 from 5.5 for the first, second and third quarters of fiscal 2010 and was in compliance with those requirements. With respect to its other debt, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.20 to 1. As of the measurement date of August 16, 2009, the Company s consolidated fixed charge coverage ratio was 1.21 to 1, funded debt to EBITDAR was 5.6 and management projects that the Company will be in compliance with its consolidated debt covenants at future measurement dates. In order to obtain the loan modification, the Company paid certain fees. As of August 16, 2009, the Company was not in compliance with the individual fixed charge coverage ratio on 18 of its restaurant properties and has obtained waivers of these requirements covering a period of longer than one year. The debt obligations of the Company which contain fixed charge coverage ratio and funded debt to EBITDAR requirements are classified as long-term, except for the amounts due within one year. If the Company does not comply with the covenants of its various debt agreements in the future, and if future waivers are not obtained, the respective lenders will have certain remedies available to them which include calling the debt, increasing the interest rates and the acceleration of payments. Noncompliance with the requirements of the Company s debt agreements, if not waived, could also trigger cross-default provisions contained in the respective agreements.

NOTE 5 STOCK OPTIONS

On April 2, 1999, the Board of Directors of the Company approved a Stock Option Plan for Executives and Managers. Under the plan 145,500 shares were reserved for the grant of options. The Stock Option Plan for Executives and Managers provides for grants to eligible participants of nonqualified stock options only. The exercise price for any option awarded under the Plan is required to be not less than 100% of the fair market value of the shares on the date that the option is granted. Options are granted by the Stock Option Committee of the Company. Options for the 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of $4.125. The plan provides that the options are exercisable after a waiting period of 6 months and that each option expires 10 years after its date of issue.

At the Company s annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 shares of stock and has essentially the same provisions as the Stock Option Plan

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for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of $3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of $.85. Options for 150,000 common shares were granted on November 6, 2008 at the closing price on that day of $1.50 per share. The options vest six months after issue and expire ten years after issue.

As of August 16, 2009, 157,500 options were outstanding, fully vested and exercisable at a weighted average exercise price of $1.57 per share. As of August 16, 2009, no options were available for grant.

The following table summarizes information about stock options outstanding at August 16, 2009:

Exercise Prices	Outstanding 8-16-09	Average Life	Number Exercisable
$3.00	7,500	0.5	7,500
$1.50	150,000	9.2	150,000
$1.57	157,500	8.8	157,500

NOTE 6 CAPITAL EXPENDITURES

The Company is required by its franchise agreements to periodically bring its restaurants into conformity with the franchisors required image. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement expenditure to be inadvisable, it has the option to cease operations at that restaurant. Over time, the estimated cost and time deadline for each restaurant may change due to a variety of circumstances and the Company revises its requirements accordingly. Also, significant numbers of restaurants may have image enhancement deadlines that coincide, in which case, the Company will adjust the actual timing of the image enhancements in order to facilitate an orderly construction schedule. During the image enhancement process, each restaurant is closed for one to two weeks, which has a negative impact on the Company s revenues and operating efficiencies. At the time a restaurant is closed for a required image enhancement, the Company may deem it advisable to make other capital expenditures in addition to those required for the image enhancement.

The franchise agreements with KFC and Taco Bell Corporation require the Company to upgrade and remodel its restaurants to comply with the franchisors current standards within agreed upon timeframes. In the case of a restaurant containing two concepts, even though only one is required to be remodeled, additional costs will be incurred because the dual concept restaurant is generally larger and contains more equipment and signage than the single concept restaurant. If a property is of usable size and configuration, the Company can perform an image enhancement to bring the building to the current image of the franchisor. If the property is not large enough to fit a drive-thru or has some other deficiency, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor s requirements. In four of the Company s restaurants, one of the franchisors may have the ability to accelerate the deadline for image enhancements. In order to meet the terms and conditions of the franchise agreements, the Company has the following obligations:

Number of Units	Period	Type	Total (1)	Required (2)	Additional (3)
1	Fiscal 2010	IE	$ 390,000	350,000	$ 40,000
1	Fiscal 2011	Relo (4)	1,400,000	1,400,000	
8	Fiscal 2011	IE	2,560,000	2,240,000	320,000
1	Fiscal 2012	Relo (4)	750,000	750,000	
8	Fiscal 2012	IE	2,560,000	2,240,000	320,000
5	Fiscal 2013	IE	1,600,000	1,400,000	200,000
1	Fiscal 2015	Rebuild	1,000,000	1,000,000	
4	Fiscal 2015	Relo (4)	5,600,000	5,600,000	
1	Fiscal 2016	Relo (4)	1,400,000	1,400,000	
4	Fiscal 2020	Relo (4)	5,600,000	5,600,000	
2	Fiscal 2020	Rebuild	2,000,000	2,000,000	
36	Total		$24,860,000	$23,980,000	$880,000

(1) These amounts are based on estimates of current construction costs and actual costs may vary.

(2) These amounts include only the items required to meet the franchisor s image requirements.

(3) These amounts are for capital upgrades performed on or which may be performed on the image enhanced

restaurants which were or may be deemed by the Company to be advantageous to the operation of the units and which may be done at the time of the image enhancement.

(4) Relocation of fee owned properties are shown net of expected recovery of capital from the sale of the former location. Relocation of leased properties assumes the capital cost of only equipment because it is not known until each lease is finalized whether the lease will be a capital or operating lease.

Capital expenditures to meet the image requirements of the franchisors and additional capital expenditures on those same restaurants being image enhanced are a large portion of the Company s annual capital expenditures. However, the Company also has

made and may make capital expenditures on restaurant properties not included on the foregoing schedule for upgrades or replacement of capital items appropriate for the continued successful operation of its restaurants. Capital expenditures in the volume and time horizon required by the image enhancement deadlines cannot be financed solely from existing cash balances and existing cashflow and the Company expects that it will have to utilize financing for a portion of the capital expenditures. The Company may use both debt and sale leaseback financing but has no commitments for either.
There can be no assurance that the Company will be able to accomplish the image enhancements and relocations required in the franchise agreements on terms acceptable to the Company. If the Company is unable to meet the requirements of a franchise agreement, the franchisor may choose to extend the time allowed for compliance or may terminate the franchise agreement.

NOTE 7 ASSETS HELD FOR SALE

The Company owns the land and building of two closed KFC restaurants and the land and building adjacent to another of its restaurants, all of which are listed for sale and are shown on the Company s consolidated balance sheet as Assets Held for Sale as of August 16, 2009.

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

Description of Business. Morgan s Foods, Inc. (the Company), which was formed in 1925, operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, Pizza Hut Express restaurants under licenses from Pizza Hut Corporation and an A&W restaurant under a license from A&W Restaurants, Inc. As of September 28, 2009, the Company operates 68 KFC restaurants, 6 Taco Bell restaurants, 13 KFC/Taco Bell 2n1 s under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation, 3 Taco Bell/Pizza Hut Express 2n1 s under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation, 1 KFC/Pizza Hut Express 2n1 under a franchise from KFC Corporation and a license from Pizza Hut Corporation and 1 KFC/A&W 2n1 operated under a franchise from KFC

Corporation and a license from A&W Restaurants, Inc. The Company s fiscal year is a 52 53 week year ending on the Sunday nearest the last day of February.

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Summary of Expenses and Operating Income as a Percentage of Revenues

	Quarter Ended		Twenty-four Weeks Ended	
	August 16, 2009	August 17, 2008	August 16, 2009	August 17, 2008
Cost of sales:				
Food, paper and beverage	31.7%	32.6%	32.0%	32.3%
Labor and benefits	27.6%	28.4%	27.8%	28.6%
Restaurant operating expenses	25.9%	26.2%	25.8%	25.7%
Depreciation and amortization	3.1%	3.4%	3.1%	3.5%
General and administrative expenses	6.2%	5.9%	6.2%	6.1%
Operating income	5.5%	3.5%	5.1%	3.9%

Revenues. The revenue increase of $153,000 in the quarter ended August 16, 2009 as compared to the prior ye