MORGANS FOODS INC
Form 10-Q
July 08, 2013

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 26, 2013

or

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

For the transition period from __________ to ____________

Commission File Number 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 (Address of principal executive offices)

44128 (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 No

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 No

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

Large accelerated filer		Accelerated filer
Non-accelerated filer company)	(do not check if a smaller reporting	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 No

As of July 5, 2013, the issuer had 4,039,147 common shares outstanding.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

MORGAN'S FOODS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Twelve Weeks Ended	
	May 26, 2013	**May 20, 2012**
Revenues	20,930,000	$20,314,000
Cost of sales:		
Food, paper and beverage	6,863,000	6,597,000
Labor and benefits	5,957,000	5,751,000
Restaurant operating expenses	4,971,000	4,975,000
Depreciation and amortization	681,000	604,000
General and administrative expenses	1,168,000	1,194,000
Loss on restaurant assets	59,000	370,000
Operating income	1,231,000	823,000
Interest expense:		
Bank debt and notes payable	180,000	230,000
Capital leases	477,000	502,000
Other (income) and expense, net	82,000	(19,000)
Income before income taxes	492,000	110,000
Provision for income taxes	85,000	71,000
Net income	$407,000	$39,000
Basic net income per common share:	$0.11	$0.01
Diluted net income per common share:	$0.11	$0.01
Basic weighted average number of shares outstanding	3,542,519	2,934,995
Diluted weighted average number of shares outstanding	3,613,868	2,934,995

See notes to these consolidated financial statements.

MORGAN’S FOODS, INC.

CONSOLIDATED BALANCE SHEET

	May 26, 2013 **(UNAUDITED)**	**March 3, 2013**
ASSETS		
Current assets:		
Cash and equivalents	$ 4,894,000	$ 2,971,000
Restricted cash	340,000	350,000
Receivables	445,000	609,000
Inventories	853,000	724,000
Prepaid expenses	473,000	812,000
Assets held for sale	583,000	583,000
Total current assets	7,588,000	6,049,000
Property and equipment:		
Land	1,075,000	1,075,000
Buildings and improvements	2,646,000	2,639,000
Property under capital leases	22,969,000	22,969,000
Leasehold improvements	12,351,000	12,308,000
Equipment, furniture and fixtures	19,078,000	18,870,000
Construction in progress	1,035,000	26,000
Total property and equipment	59,154,000	57,887,000
Less accumulated depreciation and amortization	24,150,000	23,486,000
Net book value of property and equipment	35,004,000	34,401,000
Other assets	374,000	411,000
Franchise agreements, net	651,000	689,000
Goodwill	8,950,000	8,950,000
Total assets	$ 52,567,000	$ 50,500,000
LIABILITIES AND SHAREHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Long-term debt, current	879,000	878,000
Current maturities of capital lease obligations	314,000	304,000
Accounts payable	4,509,000	3,297,000
Accrued liabilities	4,390,000	3,800,000
Total current liabilities	10,092,000	8,279,000
Long-term debt	5,527,000	7,338,000
Long-term capital lease obligations	22,022,000	22,079,000
Other long-term liabilities	10,690,000	10,812,000
Deferred tax liabilities	3,244,000	3,175,000
SHAREHOLDERS' EQUITY (DEFICIT)		
Preferred shares, 1,000,000 shares authorized, no shares outstanding		

Common stock, no par value		
Authorized shares - 25,000,000		
Issued shares - 4,073,557	41,000	30,000
Treasury shares - 34,410	(81,000)	(81,000)
Capital in excess of stated value	31,245,000	29,488,000
Accumulated deficit	(30,213,000)	(30,620,000)
Total shareholders' equity (deficit)	992,000	(1,183,000)
Total liabilities & shareholders' equity (deficit)	$ 52,567,000	$ 50,500,000

See notes to these consolidated financial statements

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

	Common Shares		**Treasury Shares**		**Capital in Excess of Stated Value**	**Accumulated Deficit**	**Total Shareholders' Equity/Deficit**
	Shares	**Amount**	**Shares**	**Amount**			
Balance March 3, 2013	2,969,405	$30,000	(34,410)	$(81,000)	$29,488,000	$(30,620,000)	$(1,183,000)
Exercise of share options	21,333	200	-	-	32,000	-	32,200
Share grant compensation	30,569	300	-	-	17,000	-	17,300
Issuance of shares	1,052,250	10,500	-	-	1,708,000	-	1,718,500
Net income	-	-	-	-	-	407,000	407,000
Balance May 26, 2013	4,073,557	$41,000	(34,410)	$(81,000)	$31,245,000	$(30,213,000)	$992,000

See notes to these consolidated financial statements.

MORGAN'S FOODS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Twelve Weeks Ended	
	May 26, 2013	**May 20, 2012**
Cash flows from operating activities:		
Net income	$407,000	$39,000
Adjustments to reconcile to net cash provided by operating activities:		
Depreciation and amortization	681,000	604,000
Amortization of deferred financing costs	19,000	20,000
Amortization of supply agreement advances	(239,000)	(217,000)
Funding from supply agreements	754,000	753,000
Deferred income taxes	69,000	56,000
Losses on restaurant assets - net	59,000	370,000
Changes in assets and liabilities:		
Receivables	131,000	101,000
Inventories	(129,000)	(13,000)
Prepaid expenses	339,000	167,000
Other assets	18,000	16,000
Accounts payable	1,176,000	185,000
Accrued liabilities	70,000	305,000
Net cash, operating activities	3,355,000	2,386,000
Cash flows from investing activities:		
Proceeds from sale of restaurants	-	471,000
Capital expenditures	(1,353,000)	(1,115,000)
Restricted cash	10,000	41,000
Net cash, investing activities	(1,343,000)	(603,000)
Cash flows from financing activities:		
Principal payments on long-term debt	(146,000)	(12,000)
Principal payments on capital lease obligations	(47,000)	(21,000)
Bank debt repayment in advance	(1,664,000)	-
Proceeds from stock transactions	1,768,000	-
Net cash, financing activities	(89,000)	(33,000)
Net change in cash and equivalents	1,923,000	1,750,000
Cash and equivalents, beginning balance	2,971,000	3,455,000
Cash and equivalents, ending balance	$4,894,000	$5,205,000
Interest paid on debt and capitalized leases	$621,000	$715,000
Cash payments for income taxes	$-	$(5,000)

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 3, 2013. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the twelve weeks ended May 26, 2013 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 3, 2013.

The Company's debt is reported at historical cost and is almost entirely comprised of variable rate borrowings. The market for variable rate 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. Management has concluded that it is not practicable to estimate the fair value of the Company's debt as of May 26, 2013.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred losses in fiscal years 2013 and 2012 and has negative working capital and an accumulated deficit at May 26, 2013. The Company has managed its liquidity in fiscal 2013 and will manage in fiscal 2014 through the refinancing of debt, the sale and leaseback of restaurant properties and the sale of additional equity. Should the Company have difficulty meeting its forecasts, this could have an adverse effect on its liquidity position. Management has taken actions to improve its cash flows, including closely monitoring its expenses and store closings for underperforming stores and expects to be able to achieve its forecast for fiscal 2014. However, there can be no assurances that our cash flow will be sufficient to allow us to continue as a going concern if we are unable to meet our projections.

NOTE 2 – RECENT ACCOUNTING PRONOUNCEMENTS

ASU 2013-01 Balance Sheet Topic 210, January 2013

Clarifies the scope of disclosures related to offsetting assets and liabilities. This release reduces the application of these disclosures to eliminate unintended consequences resulting from the application of a previously issued standard. The standard is effective for fiscal years beginning on or after January 1, 2013. Management has determined that the application of this standard did not have a material effect on the financial statements of the Company.

NOTE 3 – NET INCOME PER COMMON SHARE

Basic net income per common share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income 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 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:

	Quarter ended May 26, 2013			Quarter ended May 20, 2012		
	Net income (Numerator)	Shares (Denominator)	Per Share Amount	Net income (Numerator)	Shares (Denominator)	Per Share Amount
Basic EPS						
Income available to common shareholders	$407,000	3,542,519	$ 0.11	$39,000	2,934,995	$ 0.01
Effect of Dilutive Securities						
Weighted Average Stock Options	-	71,348		-	-	
Diluted EPS						
Income available to common shareholders	$407,000	3,613,868	$ 0.11	$39,000	2,934,995	$ 0.01

NOTE 4 – DEBT

At May 26, 2013 the Company's term loan credit agreement requires the maintenance of a consolidated debt service coverage ratio of ("DSCR") 1.80 to 1 or greater regarding all of the Company's debt. Debt service coverage ratios are calculated by dividing the cash flow before taxes and debt service ("EBITDA") for the previous 12 months by the debt service payable for the same period. The Company's term loan also requires a consolidated debt to EBITDA ("Leverage") ratio of 2.50 or less, minimum EBITDA of $3.0 million, maximum of $4.0 million in annual capital expenditures and minimum unencumbered cash of $1.5 million. The ratios are computed quarterly. At the end of the first quarter of fiscal 2014, the Company had a DSCR of 4.16 and a Leverage ratio of 1.4, being in compliance with all of the required ratios.

NOTE 5 - STOCK OPTIONS AND LTIP UNITS

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 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of $4.125, all of which have either expired or been exercised. Options for 350 common shares were granted on November 6, 2008 at the closing price on that day of $1.50 per share all of which are currently outstanding. The options vested in six months and expire ten years after 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 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, all of which have either expired or been exercised. Options for 149,650 common shares were granted on November 6, 2008 at the closing price on that day of $1.50 per share of which 124,317 are currently outstanding. The options vested in six months and expire ten years after date of issue.

As of May 26, 2013, a total of 124,667 options were outstanding, fully vested and exercisable at a weighted average exercise price of $1.50 per share. A total of 21,333 options were exercised during the first quarter of fiscal 2014 at an exercise price of $32,000. No options are available for grant and no options were granted during the current year period. The Company recorded no compensation expense during the current year period related to stock options.

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The following table summarizes information about stock options outstanding at May 26, 2013:

Exercise	Outstanding	Average	Number
Prices	5/26/13	Life	Exercisable
1.50	124,667	5.4	124,667

On April 9, 2013, the Board of Directors approved a Long-Term Incentive Plan, (“LTIP”) reserving 150,000 common shares of the Company for issuance under the LTIP. On April 9, 2013, 30,569 restricted common shares were granted under the LTIP to outside directors of the Company, leaving 119,431 shares available for future grant under the LTIP. The shares issued under the LTIP vest in six months and compensation expense related to such shares totaled $17,300 for the first quarter of fiscal 2014. Additional information regarding the LTIP may be found in a report on Form 8-K filed with the SEC on April 15, 2013.

NOTE 6 – CAPITAL EXPENDITURES

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. 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 normally closed for up 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 and the franchisor may terminate the franchise agreement for failure to meet those requirements. 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 has a deficiency which would render it unsuitable, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor’s requirements. The capital requirements for the KFC branded restaurants are included in the schedule based on the requirements of the KFC Remodel Agreement and the Taco Bell restaurants and are shown at the time management believes they will be done so that all of them can comfortably be completed before the due date for the group.

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Number of Units	**Period**	**Type**	**Capital Cost (1)**
3	Fiscal 2014	Remodels	650,000
2	Fiscal 2014	Relo (2)	800,000
	Total 2014		**1,450,000**
4	Fiscal 2015	Remodels	**950,000**
7	Fiscal 2016	Remodels	**1,745,000**
4	Fiscal 2017	Remodels	1,000,000
1	Fiscal 2017	Refresh (3)	100,000
2	Fiscal 2017	Taco Bell	800,000
	Total 2017		**1,900,000**
3	Fiscal 2018	Remodels	740,000
1	Fiscal 2018	Refresh (3)	100,000
2	Fiscal 2018	Taco Bell	800,000
	Total 2018		**1,640,000**
1	Fiscal 2019	Remodels	200,000
3	Fiscal 2019	Remodels	300,000
2	Fiscal 2019	Taco Bell	800,000
	Total 2019		**1,300,000**
7	Fiscal 2020	Refresh (3)	675,000
1	Fiscal 2020	Taco Bell	400,000
	Total 2020		**1,075,000**
7	Fiscal 2021	Refresh (3)	**625,000**
7	Fiscal 2022		