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MEXICAN RESTAURANTS INC
Form 10-Q
November 07, 2003

UNITED STATES
SECURITIES & EXCHANGE COMMISSION
WASHINGTON, D.C. 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 SEPTEMBER 28, 2003

OR

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

For the transition period from _____ to _____

Commission file number: 0-28234

MEXICAN RESTAURANTS, INC.
(Exact name of registrant as specified in its charter)

TEXAS
State or other jurisdiction of
incorporation or organization)

76-0493269
(IRS Employer Identification Number)

1135 EDGEBROOK, HOUSTON, TEXAS
(Address of Principal Executive Offices)

77034-1899
(Zip Code)

Registrant's telephone number, including area code: 713-943-7574

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 is an accelerated filer (as
defined in Rule 12b-2 of the Exchange Act).

Yes No
--- ---

Number of shares outstanding of each of the issuer's classes of common stock, as

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of October 15, 2003: 3,384,605 SHARES OF COMMON STOCK, PAR VALUE \$.01.

PART 1 - FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

| ASSETS | UNAUDITED) 9/28/2003 | (AUDITED) 12/29/2002 |
|---|-------------------------|-------------------------|
| | ----- | ----- |
| Current assets: | | |
| Cash and cash equivalents | \$ 271,288 | \$ 526,536 |
| Royalties receivable | 169,961 | 142,031 |
| Other receivables | 500,164 | 659,901 |
| Inventory | 513,373 | 557,555 |
| Taxes receivable | 359,714 | 382,882 |
| Prepaid expenses and other current assets | 545,971 | 592,075 |
| | ----- | ----- |
| Total current assets | 2,360,471 | 2,860,980 |
| | ----- | ----- |
| Property, plant and equipment | 28,879,862 | 27,347,171 |
| Less accumulated depreciation | (12,360,976) | (10,706,035) |
| | ----- | ----- |
| Net property, plant and equipment | 16,518,886 | 16,641,136 |
| Deferred tax assets | 252,025 | 454,453 |
| Property held for resale | 963,605 | 963,605 |
| Other assets | 8,077,276 | 8,062,605 |
| | ----- | ----- |
| | \$ 28,172,263 | \$ 28,982,779 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Current installments of long-term debt | \$ 1,500,000 | \$ 1,000,000 |
| Accounts payable | 1,700,587 | 1,879,171 |
| Accrued sales and liquor taxes | 460,884 | 441,264 |
| Accrued payroll and taxes | 945,466 | 999,403 |
| Accrued expenses | 792,854 | 1,277,525 |
| | ----- | ----- |
| Total current liabilities | 5,399,791 | 5,597,363 |
| | ----- | ----- |
| Long-term debt, net of current portion | 2,000,000 | 3,400,000 |
| Other liabilities | 884,781 | 852,214 |
| Deferred gain | 2,029,391 | 2,185,498 |
| Stockholders' equity: | | |
| Preferred stock, \$.01 par value, 1,000,000 shares authorized | -- | -- |
| Capital stock, \$.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued | 47,327 | 47,327 |
| Additional paid-in capital | 20,121,076 | 20,121,076 |
| Retained earnings | 9,457,343 | 8,577,725 |

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| | | |
|---|---------------|---------------|
| Deferred compensation | (57,933) | (88,911) |
| Treasury stock, cost of 1,348,100 common shares | (11,709,513) | (11,709,513) |
| | ----- | ----- |
| Total stockholders' equity | 17,858,300 | 16,947,704 |
| | ----- | ----- |
| | \$ 28,172,263 | \$ 28,982,779 |
| | ===== | ===== |

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MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

| | 13-WEEK PERIOD ENDED 09/28/03 | 13-WEEK PERIOD ENDED 09/29/03 | 39-WEEK PERIOD ENDED 9/28/03 |
|----------------------------------|-------------------------------------|-------------------------------------|------------------------------------|
| | ----- | ----- | ----- |
| Revenues: | | | |
| Restaurant sales | \$ 14,857,758 | \$ 14,758,163 | \$ 43,7 |
| Franchise fees and royalties | 296,362 | 331,690 | 8 |
| Other | 2,934 | 26,872 | |
| | ----- | ----- | ----- |
| | 15,157,054 | 15,116,725 | 44,6 |
| | ----- | ----- | ----- |
| Costs and expenses: | | | |
| Cost of sales | 4,131,939 | 3,961,890 | 12,1 |
| Labor | 4,944,326 | 4,916,765 | 14,6 |
| Restaurant operating expenses | 3,827,094 | 3,776,927 | 11,1 |
| General and administrative | 1,333,358 | 1,282,531 | 3,9 |
| Depreciation and amortization | 600,290 | 562,967 | 1,7 |
| Pre-opening costs | 1,857 | -- | |
| Restaurant closure costs | 52,648 | -- | |
| | ----- | ----- | ----- |
| | 14,891,512 | 14,501,080 | 43,7 |
| | ----- | ----- | ----- |
| Operating income | 265,542 | 615,645 | 8 |
| | ----- | ----- | ----- |
| Other income (expense): | | | |
| Interest income | 6,512 | 71,617 | |
| Interest expense | (60,821) | (97,339) | (1 |
| Other, net | 51,256 | 70,674 | 5 |
| | ----- | ----- | ----- |
| | (3,053) | 44,952 | 3 |
| | ----- | ----- | ----- |
| Income before income tax expense | 262,489 | 660,597 | 1,2 |
| Income tax expense | 65,822 | 202,803 | 3 |
| | ----- | ----- | ----- |

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| | | | |
|---|------------|------------|-------|
| Net income | \$ 196,667 | \$ 457,794 | \$ 8 |
| | ===== | ===== | ===== |
| Basic income per share | \$ 0.06 | \$ 0.13 | \$ |
| | ===== | ===== | ===== |
| Diluted income per share | \$ 0.06 | \$ 0.13 | \$ |
| | ===== | ===== | ===== |
| Weighted average number of shares (basic) | 3,384,605 | 3,417,748 | 3,3 |
| | ===== | ===== | ===== |
| Weighted average number of shares (diluted) | 3,422,013 | 3,489,274 | 3,4 |
| | ===== | ===== | ===== |

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MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

| | |
|---|-------------|
| | 39-WEEK |
| | ----- |
| | 09/28/03 |
| | ----- |
| Cash flows from operating activities: | |
| Net income | \$ 879,620 |
| Adjustments to reconcile net income to net cash provided by operating activities: | |
| Deferred compensation | 30,978 |
| Depreciation and amortization | 1,773,000 |
| Deferred gain amortization | (156,107) |
| Asset impairments and restaurant closure costs | 33,498 |
| Deferred taxes | 202,428 |
| Loss (gain) on sale of property, plant & equipment | (476,627) |
| Changes in assets and liabilities: | |
| Royalties receivable | (27,930) |
| Other receivables | 159,737 |
| Income tax receivable/payable | 23,168 |
| Inventory | 44,182 |
| Prepaid and other current assets | 46,104 |
| Other assets | (79,954) |
| Accounts payable | (178,584) |
| Accrued expenses and other liabilities | (518,991) |
| Other liabilities | 32,567 |
| | ----- |
| Total adjustments | 907,469 |
| | ----- |
| Net cash provided by operating activities | 1,787,089 |
| | ----- |
| Cash flows from investing activities: | |
| Insurance proceeds from fire loss on building | 488,629 |
| Purchase of property, plant and equipment | (1,630,966) |

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| | |
|---|-------------|
| Proceeds from sale of property, plant and equipment | -- |
| Payment received on note for sale of property | -- |
| | ----- |
| Net cash used in investing activities | (1,142,337) |
| | ----- |
| Cash flows from financing activities: | |
| Net borrowings (payments) under line of credit | (900,000) |
| Purchase of treasury stock | -- |
| | ----- |
| Net cash used in financing activities | (900,000) |
| | ----- |
| Decrease in cash and cash equivalents | (255,248) |
| | ----- |
| Cash and cash equivalents at beginning of period | 526,536 |
| | ----- |
| Cash and cash equivalents at end of period | \$ 271,288 |
| | ===== |
| Supplemental disclosure of cash flow information: | |
| Cash paid during the period: | |
| Interest | \$ 197,736 |
| Income Taxes | \$ 240,600 |
| Non-cash investing and financing activity: | |
| Sale of property for note receivable | \$ -- |

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MEXICAN RESTAURANTS, INC. AND CONSOLIDATED SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

In the opinion of Mexican Restaurants, Inc. (the "Company"), the accompanying consolidated financial statements contain all adjustments (consisting only of normal recurring accruals and adjustments) necessary for a fair presentation of the consolidated financial position as of September 28, 2003, and the consolidated statements of income for the 13-week and 39-week periods and cash flows for the 39-week period ended September 28, 2003 and September 29, 2002. The consolidated statements of income for the 13-week and 39-week periods ended September 28, 2003 are not necessarily indicative of the results to be expected for the full year.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In June 2001, FASB issued SFAS No. 143, Accounting for Asset Retirement Obligations. SFAS No. 143 requires the Company to record the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The Company also records a corresponding asset that is depreciated over the life of the asset. Subsequent to the initial measurement of the asset retirement obligation, the obligation will be adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation. The Company adopted SFAS No. 143 on January 1, 2003. The adoption of

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SFAS No. 143 did not have a material effect on the Company's financial statements.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 amends existing guidance on reporting gains and losses on the extinguishment of debt to prohibit the classification of the gain or loss as extraordinary, as the use of such extinguishments have become part of the risk management strategy of many companies. SFAS No. 145 also amends SFAS No. 13 to require sale-leaseback accounting for certain lease modifications that have economic effects similar to sale-leaseback transactions. The Company adopted SFAS No. 145 on January 1, 2003. The adoption of SFAS No. 145 did not have a material effect on the Company's financial statements.

In June 2002, the FASB issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies Emerging Issues Task Force (EITF) Issue 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity. The Company adopted SFAS No. 146 on January 1, 2003. The adoption of SFAS No. 146 did not have a material effect on the Company's financial statements.

In November 2002, the FASB issued Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others, and interpretation of FASB Statements No. 5, 57 and 107 and a rescission of FASB Interpretation No. 34. This Interpretation elaborates on the disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under guarantees issued. The Interpretation also clarifies that a guarantor is required to recognize, at inception of a guarantee, a liability for the fair value of the obligation undertaken. The initial recognition and measurement provisions of the Interpretation were applicable to guarantees issued or modified after December 31, 2002 and did not have a material effect on the Company's financial statements.

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. This Statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

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2. ACCOUNTING POLICIES

During the interim periods the Company follows the accounting policies set forth in its consolidated financial statements in its Annual Report and Form 10-K (file number 0-28234). Reference should be made to such financial statements for information on such accounting policies and further financial details.

3 NET INCOME PER COMMON SHARE

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Basic income per share is based on the weighted average shares outstanding without any dilutive effects considered. Diluted income per share reflects dilution from all contingently issuable shares, including options and warrants. As of September 28, 2003 and September 29, 2002, the Company had 1,036,470 and 1,048,470 options and warrants outstanding, respectively. As of September 28, 2003 and September 29, 2002, such stock options and warrants have the effect of increasing basic weighted average shares outstanding by 37,408 and 71,526 for the 13-week periods and 40,274 and 76,050 for the 39-week periods, respectively.

4. SFAS NO. 148. "ACCOUNTING FOR STOCK-BASED COMPENSATION"

In December 2002, the FASB issued SFAS No. 148, Accounting for Stock-Based Compensation - Transition and Disclosure, an amendment of FASB Statement No. 123. This Statement amends FASB Statement No. 123, Accounting for Stock-Based Compensation, to provide alternative methods of transition for a voluntary change to the fair value method of accounting for stock-based employee compensation. In addition, this Statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements. Certain of the disclosure modifications are required for fiscal years ending after December 15, 2002 and are included in the notes to these consolidated financial statements.

The Company has adopted the disclosure-only provisions of SFAS No. 123, "(Accounting for Stock-Based Compensation,)" and has accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "(Accounting for Stock Issued to Employees)" and related interpretations. Accordingly, no compensation cost has been recognized for stock options or warrants. Had compensation cost for the Company's outstanding stock options and warrants been determined based on the fair value at the grant date for awards consistent with the provisions of SFAS No. 123, the Company's net income and net income per share would have been reduced to the pro forma amounts indicated below for the 13 week periods and 39 week periods ended September 29, 2003 and September 30, 2002, respectively:

| | |
|---|---------------|
| | 1 |
| | ----- |
| | 9/29/ |
| | ----- |
| Net income - as reported..... | \$ 196, |
| Proforma net income - pro forma for SFAS No. 123..... | 173, |
| Net income per share basic and diluted - as reported..... | 0 |
| Pro forma net income per share basic and diluted- pro forma for SFAS No. 123..... | 0 |
| | 3 |
| | ----- |
| | 9/29/ |
| | ----- |
| Net income - as reported..... | \$ 879, |
| reported..... | reported..... |

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| | |
|---|------|
| Proforma net income - pro forma for SFAS No. 123..... | 847, |
| Net income per share basic and diluted - as reported..... | 0 |
| Pro forma net income per share basic and diluted- pro forma for SFAS No. 123..... | 0 |

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements involve known and unknown risks, uncertainties and other factors which may cause the actual results, performance or achievements of the Company to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others, the following: growth strategy; dependence on executive officers; geographic concentration; increasing susceptibility to adverse conditions in the region; changes in consumer tastes and eating habits; national, regional or local economic and real estate conditions; demographic trends; inclement weather; traffic patterns; the type, number and location of competing restaurants; inflation; increased food, labor and benefit costs; the availability of experienced management and hourly employees; seasonality and the timing of new restaurant openings; changes in governmental regulations; dram shop exposure; and other factors not yet experienced by the Company. The use of words such as "believes", "anticipates", "expects", "intends" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. Readers are urged to carefully review and consider the various disclosures made by the Company in this report and in the Company's Annual Report and Form 10-K for the fiscal year ended December 29, 2002, that attempt to advise interested parties of the risks and factors that may affect the Company's business.

RESULTS OF OPERATIONS

Revenues. The Company's revenues for the third quarter of fiscal 2003 were up \$40,329 or 0.3% to \$15.2 million compared with the same quarter one year ago. Restaurant sales for the third quarter of fiscal 2003 were up \$99,595 or 0.7% compared with the same quarter one year ago, to \$14.9 million. Total system sales at restaurants operating in both fiscal quarters ("same-stores") decreased 2.8%. Company-owned same-store sales for the quarter decreased 3.3%. Franchise-owned same-store sales for the quarter decreased 2.2%. The Company believes the decline in same-store sales is due primarily to the weak economy in the regions where the Company's stores are concentrated.

On a year-to-date basis, the Company's revenues were down \$1.4 million or 2.9% to \$44.6 million compared with the same 39-week period in fiscal 2002. Restaurant sales were down \$1.2 million or 2.7% to \$43.8 million compared with the same 39-week period in fiscal 2002. The decrease reflects a decline in same-store sales, partially offset by one new restaurant opening. Year-to-date total system same-store sales decreased 2.6% from the comparable period in fiscal 2002. Company-owned same-store sales for the 39-week period decreased 3.9% and franchise-owned same-store sales for the 39-week period decreased 0.8% from the comparable period in fiscal 2002.

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Costs and Expenses. Cost of sales, consisting primarily of food and beverage costs, but also including paper and supplies, increased 100 basis points as a percentage of restaurant sales in the third quarter of fiscal 2003 to 27.8% from 26.8% for the same quarter in fiscal 2002. The increase reflects higher cheese and produce expenses.

On a year-to-date basis, cost of sales increased 60 basis points as a percentage of restaurant sales to 27.7% from 27.1% from the comparable period in fiscal 2002. The increase reflects higher cheese, produce, liquor and paper and supply expenses.

As a percentage of restaurant sales, labor and other related expenses did not change from the comparable period in fiscal 2002, remaining at 33.3% for the third quarter. Declining same-store sales has put pressure on labor costs given the semi-fixed nature of management, workers compensation and health insurance expenses; however, reduced over-time expense offset most of that pressure in the third quarter.

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On a year-to-date basis, labor and other related expenses as a percentage of restaurant sales increased 60 basis points to 33.5% from 32.9% for the comparable period in fiscal 2002. The increase was due to the same factors discussed above.

Restaurant operating expenses, which primarily includes rent, property taxes, utilities, repair and maintenance, liquor taxes and advertising, as a percentage of restaurant sales increased 20 basis points to 25.8% in the third quarter of fiscal 2003 from 25.6% in the same quarter in fiscal 2002. The increase reflects higher utility expenses, higher insurance premiums, and fixed restaurant expenses relative to declining same-store sales.

On a year-to-date basis, restaurant operating expenses increased 70 basis points to 25.4% from 24.7% for the comparable period in fiscal 2002. The increase was due to the same factors discussed above.

As a percentage of total sales, general and administrative expenses increased 30 basis points to 8.8% in the third quarter of fiscal 2003 from 8.5% in the same quarter in fiscal 2002, reflecting a reclass of Texas franchise taxes that were based on capital from income tax expense to general and administrative expense.

On a year-to-date basis, general and administrative expenses increased as a percentage of total sales 40 basis points to 8.9% in fiscal 2003 compared with 8.5% for the comparable period in fiscal 2002. The increase, as a percentage of sales, reflects declining same-store sales and the reclass of Texas franchise taxes as stated above.

Depreciation and amortization expense as a percentage of total sales increased 30 basis points to 4.0% in the third quarter of fiscal 2003 from 3.7% for the same quarter in fiscal 2002. The increase, in part, reflects declining same-store sales. In absolute dollars, depreciation and amortization increased \$38,901 to \$600,290 for the third quarter of fiscal 2003 due to new asset additions and restaurant remodels.

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On a year-to-date basis, depreciation and amortization expense as a percentage of total sales increased 40 basis points to 4.0% from 3.6% for the comparable period in fiscal 2002. The increase, in part, reflects declining same-store sales. In absolute dollars, depreciation and amortization increased \$112,982 to \$1,773,000 for the comparable 39-week period due to new asset additions and restaurant remodels.

The Company did not open new restaurants in the first or third quarters of fiscal 2003, and opened one new restaurant in the second quarter of 2003, incurring \$95,526 in pre-opening expenses year-to-date. No new restaurants were opened during the 39-week period in fiscal year 2002.

Other Income (Expense). Net other income (expense) decreased from income to an expense by \$48,005 compared with the third quarter one year ago. Interest income and other, net, decreased \$65,105 to \$6,512 and \$19,418 to \$51,256, respectively, compared with the third quarter one year ago. Last year the Company received \$53,935 of interest income from the IRS for tax refunds previously recorded in the third quarter of fiscal 2002. Also in the third quarter of fiscal 2002, the Company recorded \$60,103 of business interruption insurance due to fire damage at the Company's Humble, Texas location. For the third quarter of fiscal 2003, interest expense decreased by \$36,518 to \$60,821 compared with the third quarter in fiscal 2002, reflecting a lower average debt balance in the third quarter of fiscal 2003. Total debt as of September 28, 2003 was \$3.5 million compared with \$5.0 million as of September 29, 2002.

On a year-to-date basis, interest expense decreased by \$104,575 to \$196,713, reflecting a lower average debt balance. Other, net, increased \$467,388 to \$567,441, reflecting a gain of \$477,508 for insurance proceeds received from fire damage at the Humble, Texas restaurant location.

Income Tax Expense. For the third quarter of fiscal 2003, the Company's effective tax rate was 25.1% as compared with 30.7% in the same quarter in fiscal 2002. The effective tax rate is a

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function of year-to-date annualizing, the effects of permanent and temporary differences, the alternative minimum tax and the utilization of tax credits.

LIQUIDITY AND CAPITAL RESOURCES

The Company met its capital requirements for the 39-weeks ended September 28, 2003 with cash generated by operations and cash reserves from the previous year. As of September 28, 2003, the Company's operations generated approximately \$1.8 million in cash, as compared with \$3.2 million in the same period one year ago. As of September 28, 2003, the Company had a working capital deficit of approximately \$3.0 million, of which \$1.5 million is due to Fleet National Bank under the terms of its credit agreement (\$250,000 payment per quarter on the term note and \$500,000 due on the revolver by June 29, 2004). A working capital deficit is common in the restaurant industry, since restaurant companies do not typically require a significant investment in either accounts receivable or inventory.

The Company's principal capital requirements are the funding of routine capital expenditures, new restaurant development or

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acquisitions and remodeling of older units. During the first 39 weeks of fiscal 2003, capital expenditures on property, plant and equipment were approximately \$1.6 million as compared to \$1.3 million for the first 39 weeks of fiscal 2002. The capital expenditures were for necessary replacement of equipment and leasehold improvements in various older units. On April 17, 2003, the Company acquired an existing franchise restaurant in a sale-leaseback transaction. The Company closed, remodeled and reopened the restaurant on May 19, 2003, spending \$380,747 on the remodel. The Company completed the remodel of one additional restaurant during the third quarter of fiscal year 2003. The Company estimates its capital expenditures for the remainder of the fiscal year will be approximately \$250,000.

On June 29, 2001, the Company re-financed \$7.8 million of its debt with Fleet National Bank. The credit facility with Fleet is for \$10.0 million and consists of a \$5.0 million term note that requires quarterly principal payments of \$250,000 and matures on June 29, 2006 and a \$5.0 million revolving line of credit that matures on June 29, 2004. The interest rate is either the prime rate or LIBOR plus a stipulated percentage. Accordingly, the Company is impacted by changes in the prime rate and LIBOR. The Company is subject to a non-use fee of 0.5% on the unused portion of the revolver from the date of the credit agreement. The Company paid down \$900,000 of its indebtedness during the 39 weeks of fiscal year 2003. As of September 28, 2003, the Company had \$3.5 million outstanding on the credit facility. In August 2003, the Fleet approved an amendment of the existing credit facility, effective June 29, 2003 that amended the minimum rolling twelve-month EBITDA and the cash flow coverage covenants. As of September 28, 2003, the Company was in compliance with covenants as amended. The Company expects to be in compliance with the covenants in the credit facility, as amended, for the next twelve months.

Over the last several years, the Company's debt was incurred to carry out acquisitions, to develop new restaurants, and to remodel existing restaurants, as well as to accommodate other working capital needs. The Company anticipates that it will use excess cash flow during the remainder of fiscal year 2003 to pay down debt by approximately \$400,000 (approximately \$300,000 less than what was estimated as of June 29, 2003, reflecting fees and other expenses that will be paid in the fourth quarter relating to the Company's acquisition of franchisee restaurants as described below).

On September 25, 2003, the Company signed an agreement to acquire 13 restaurants and related assets from its Beaumont-based franchisee, Thomas Harken, and Mr. Harken's operating partner, Victor Gonzalez, for a total consideration of approximately \$13.75 million. The restaurants to be acquired include eight Casa Ole restaurants located in Southeast Texas, two Casa Ole restaurants located in Southwest Louisiana, and three Crazy Jose's restaurants located in Southeast Texas. In fiscal

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year 2002, these restaurants had combined sales of over \$20.0 million. The transaction is expected to close by the end of this fiscal year.

On August 12, 2003, the Company decided to apply for listing on the Nasdaq SmallCap Market after receiving notice from the Nasdaq Listing Qualifications Staff that the minimum market value of its publicly held shares of its common stock did not comply with the requirements for continued listing on the Nasdaq National Market. The Company was accepted on to the Nasdaq SmallCap Market in mid-September.

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The Company's management believes that with its operating cash flow and the Company's revolving line of credit with Fleet National Bank, funds will be sufficient to meet operating requirements and to finance routine capital expenditures and remodels through the end of the 2003 fiscal year. Unless the Company violates an important debt covenant, the Company's credit facility with Fleet National Bank is not subject to triggering events that would cause the credit facility to become due sooner than the maturity dates described above.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company does not have or participate in transactions involving derivative, financial and commodity instruments. The Company's long-term debt bears interest at floating market rates. Based on amount outstanding at September 28, 2003, a 1% change in interest rates would change interest expense by \$8,750.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, the Company carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's President and Chief Executive Officer together with the Company's Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined under Rule 13a-15(e) under the Securities Exchange Act of 1934. Based upon the evaluation, the Company's President and Chief Executive Officer and the Company's Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them to material information relating to the Company (including its subsidiaries) required to be included in the Company's periodic filings with the Securities and Exchange Commission. There have been no significant changes in the Company's internal controls or in other factors that could significantly affect internal controls subsequent to the date of the evaluation.

PART II - OTHER INFORMATION

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) EXHIBITS

| Exhibit Number ----- | Document Description ----- |
|----------------------------|---|
| 10.1 | Asset Purchase Agreement by and among Casa as Buyer, and Mexican Restaurants, Inc., as Casa Ole of Beaumont, Inc., Casa Ole of Lak Inc., Harken Real Estate Company, Inc., Cra Restaurant Group, Inc. and Crazy Jose's Fra Inc., as Seller, and Thomas L. and Melba Ha Victor M. and Dolores Gonzalez, as Sharehol September 25, 2003 |
| 31.1 | Certification of Chief Executive Officer Pu Section 302 of the Sarbanes-Oxley Act of 20 |

| Exhibit Number ----- | Document Description ----- |
|----------------------------|--|
| 31.2 | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

(b) REPORTS ON FORM 8-K

There were four reports on Form 8-K filed during the Company's fiscal quarter ended September 28, 2003.

On August 4, 2003, the Company filed a report on Form 8-K under Item 5 - Other Events, and under Item 7 - Financial Statements and Exhibits, including its August 1, 2003 press release announcing that the Company had received notice from the Nasdaq Listing Qualifications Staff that it failed to comply with the minimum market value of publicly held securities required for continued listing on the Nasdaq SmallCap Market. On August 13, 2003, the Company filed a report on Form 8-K under Item 5 - Other Events, and under Item 7 - Financial Statements and Exhibits, including its August 12, 2003 press release announcing that it had decided to apply for listing on the Nasdaq SmallCap Market.

On August 19, 2003, the Company filed a report on Form 8-K which furnished information under Item 7 - Financial Statements and Exhibits, including its August 18, 2003 press release announcing its financial results for the second quarter ended June 29, 2003. On September 2, 2003, the Company filed a report on Form 8-K under Item 5 - Other Events, and under Item 7 - Financial Statements and Exhibits, including its September 25, 2003 press release announcing its agreement to acquire certain restaurants and related assets from its Beaumont-based franchisee.

SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

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MEXICAN RESTAURANTS, INC.

Dated: November 6, 2003

By: /s/ Curt Glowacki

Curt Glowacki
Chief Executive Officer
(Principal Executive Officer)

Dated: November 6, 2003

By: /s/ Andrew J. Dennard

Andrew J. Dennard
Senior Vice President, Chief Financial
Officer & Treasurer
(Principal Financial Officer and
Principal Accounting Officer)

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EXHIBIT INDEX

| Exhibit Number ----- | Document Description ----- |
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| 10.1 | Asset Purchase Agreement by and among Casa Ole East, Ltd. as Buyer, and Mexican Restaurants, Inc., as Guarantor, Casa Ole of Beaumont, Inc., Casa Ole of Lake Charles, Inc., Harken Real Estate Company, Inc., Crazy Jose's Restaurant Group, Inc. and Crazy Jose's Franchising, Inc., as Seller, and Thomas L. and Melba Harken and Victor M. and Dolores Gonzalez, as Shareholders dated September 25, 2003 |
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