MORGANS FOODS INC
Form 10-K
June 02, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-K
Annual Report Pursuant to Section 13 or 15(d)
of the Securities Exchange Act of 1934
For the fiscal year ended March 2, 2008 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 Number)

4829 Galaxy Parkway, Suite S, Cleveland, OH 44128

(Address of principal executive officers) (Zip Code)

Registrant s telephone number, including area code: (216) 359-9000
Securities registered pursuant to Section 12(b) of the Act: None

Title of each class	Name of each exchange on which registered
Common Shares, Without Par Value	

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No þ

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 and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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 registration is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

As of August 12, 2007, the aggregate market value of the common stock held by nonaffiliates of the Registrant was $19,165,413.

As of May 14, 2008, the Registrant had 2,934,995 common shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the definitive Proxy Statement to security holders for the 2008 annual meeting, to be filed with the Securities and Exchange Commission on or before June 27, 2008.

PART I

ITEM 1. BUSINESS

General

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 May 23, 2008, the Company operates 72 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.

Restaurant Operations

The Company s KFC restaurants prepare and sell the distinctive KFC branded chicken products along with related food items. All containers and packages bear KFC trademarks. The Company s Taco Bell restaurants prepare and sell a full menu of quick service Mexican food items using the appropriate Taco Bell containers and packages. The KFC/Taco Bell 2n1 restaurants operated under franchise agreements from KFC Corporation and license agreements from Taco Bell Corporation prepare and sell a limited menu of Taco Bell items as well as the full KFC menu while those operated under franchise agreements from both KFC Corporation and Taco Bell Corporation offer a full menu of both KFC and Taco Bell items. The Taco Bell/Pizza Hut Express 2n1 restaurants prepare and sell a full menu of Taco Bell items and a limited menu of Pizza Hut items. The KFC/Pizza Hut Express 2n1 restaurant prepares and sells a full menu of KFC items and a limited menu of Pizza Hut items. The KFC/A&W 2n1 sells a limited menu of A&W items and a full menu of KFC items.

Of the 96 KFC, Taco Bell and 2n1 restaurants operated by the Company as of May 23, 2008, 16 are located in Ohio, 57 in Pennsylvania, 12 in Missouri, 2 in Illinois, 7 in West Virginia and 2 in New York. The Company was one of the first KFC Corporation franchisees and has operated in excess of 20 KFC franchises for more than 25 years. Operations relating to these units are seasonal to a certain extent, with higher sales generally occurring in the summer months.

Franchise Agreements

All of the Company s KFC and Taco Bell restaurants are operated under franchise agreements with KFC Corporation and Taco Bell Corporation, respectively. The Company s KFC/Taco Bell 2n1 restaurants are operated under franchises from KFC Corporation and either franchises or licenses from Taco Bell Corporation. The Taco Bell/Pizza Hut Express 2n1 s are operated under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation. The KFC/Pizza Hut Express 2n1 restaurant is operated under a franchise from KFC Corporation and a license from Pizza Hut Corporation. The KFC/A&W

2n1 is operated under a franchise from KFC Corporation and a license from A&W Restaurants, Inc. The Company considers retention of these agreements to be important to the success of its restaurant business and believes that its relationships with KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc. are satisfactory. For KFC products, the Company is required to pay royalties of 4% of gross revenues and to expend an additional 5.5% of gross revenues on national and local advertising pursuant to its franchise agreements. For Taco Bell products in KFC/Taco Bell 2n1 restaurants operated under license agreements from Taco Bell Corporation and franchise agreements from KFC Corporation the Company is required to pay royalties of 10% of Taco Bell gross revenues and to make advertising fund contributions of 1/2% of Taco Bell gross revenues. For Taco Bell product sales in restaurants operated under Taco Bell franchises the Company is required to pay royalties of 5.5% of gross revenues and to expend an additional 4.5% of gross revenues on national and local advertising. For Pizza Hut products in 2n1 restaurants the Company is required to pay royalties of 5.5% of Pizza Hut gross revenues and to expend an additional 4.5% of Pizza Hut gross revenues on national and local advertising. For A&W products in 2n1 restaurants the Company is required to pay royalties of 7% of A&W gross revenues and to expend an additional 4% of A&W gross revenues on national and local advertising.

In May 1997, the Company renewed substantially all of its then existing franchise agreements for twenty years. New 20 year franchise agreements were obtained for all 54 restaurants acquired in July 1999. Subject to satisfying KFC and Taco Bell requirements for restaurant image and other matters, franchise agreements are renewable at the Company s option for successive ten year periods. The franchise and license agreements provide that each KFC, Taco Bell, Pizza Hut Express and A&W unit is to be inspected by KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation and A&W Restaurants, Inc., respectively, approximately three or four times per year. These inspections cover product preparation and quality, customer service, restaurant appearance and operation.

Competition

The quick service restaurant business is highly competitive and is often affected by changes in consumer tastes; national, regional, or local economic conditions, demographic trends, traffic patterns; the type, number and locations of competing restaurants and disposable purchasing power. Each of the Company s KFC, Taco Bell and 2n1 restaurants competes directly or indirectly with a large number of national and regional restaurant operations, as well as with locally owned restaurants, drive-ins, diners and numerous other establishments which offer low- and medium-priced chicken, Mexican food, pizza, hamburgers and hot dogs to the public.

The Company s KFC, Taco Bell and 2n1 restaurants rely on innovative marketing techniques and promotions to compete with other restaurants in the areas in which they are located. The Company s competitive position is also enhanced by the national advertising programs sponsored by KFC Corporation, Taco Bell Corporation, Pizza Hut Corporation, A&W Restaurants, Inc. and their franchisees. Emphasis is placed by the Company on its control systems and the training of personnel to maintain high food quality and good service. The Company believes that its KFC, Taco Bell and 2n1 restaurants are competitive with other quick service restaurants on the basis of the important competitive factors in the restaurant business which include, primarily, restaurant location, product price, quality and differentiation, and also restaurant and employee appearance.

Government Regulation

The Company is subject to various federal, state and local laws affecting its business. Each of the Company s restaurants must comply with licensing and regulation by a number of governmental authorities, which include health, sanitation, safety and fire agencies in the state or municipality in which the restaurant is located.

The Company is also subject to federal and state laws governing such matters as employment and pay practices, overtime and working conditions. The bulk of the Company s employees are paid on an hourly basis at rates not less than the federal and state minimum wages.

The Company is also subject to federal and state child labor laws which, among other things, prohibit the use of certain hazardous equipment by employees 18 years of age or younger.

Suppliers

The Company s food is sourced from suppliers approved by its franchisors. Much of this purchasing is done through a franchisee owned cooperative and the Company contracts for the distribution of the goods to its restaurants through McLane Foodservice, Inc.

Growth

The Company built a new KFC/Taco Bell 2n1 and relocated an existing Taco Bell to that facility in fiscal 2008 and no new restaurants were added in fiscal 2007.

Employees

As of May 14, 2008, the Company employed approximately 2,139 persons, including 49 administrative and 248 managerial employees. The balance are hourly employees, most of whom are part-time. None of the Company s employees are represented by a labor union. The Company considers its employee relations to be satisfactory.

ITEM 1A. RISK FACTORS

The Company faces a variety of risks inherent in general business and in the restaurant industry specifically, including operational, legal, regulatory and product risks. Certain significant factors that could adversely affect the operations and results of the Company are discussed below. Other risk factors that the Company cannot anticipate may develop, including risk factors that the Company does not currently consider to be significant.

Outbreak of Avian Flu or Mad Cow Disease

Due to the Company s reliance on poultry in its menu items, an outbreak of the Avian Flu in the United States could cause a shortage of chicken or could cause unreasonable panic in the public related to the consumption of chicken products, either of which would likely have a significant adverse impact on the Company s business. To a lesser extent the Company also uses beef in certain of its menu items and the conditions discussed above could apply to an outbreak of Mad Cow disease.

Image Enhancement and Capital Expenditure Requirements

The Company faces significant image enhancement and relocation requirements in future fiscal years as described under Lease Obligations and Other Commitments in Part II of this report. There is no assurance that the Company will be able to obtain sale/leaseback or debt financing on terms which it finds reasonably acceptable to fund these obligations when due. Lack of acceptable financing could have a material adverse affect on the operations of the Company, including the loss of restaurants subject to enhancement or relocation requirements under applicable franchise agreements.

Contamination of the Food Supply

The food supply in general is subject to the accidental or intentional introduction of contaminants which can cause illness or death in humans. To the extent that the Company s food supplies become impacted by any of these contaminants, the Company s revenue could be significantly reduced and the Company could be subjected to related liability claims.

Litigation

The Company is involved in various commercial activities in the operation of its restaurants. These activities may generate the potential for legal claims against the Company. While many of these risks are covered by insurance, the costs of litigating large claims and any potential resulting uninsured liability could have a material adverse effect on the Company s results of operations.

Environmental Liabilities

In operating its restaurants, the Company is the owner of many real estate parcels. Environmental problems at any of these sites could cause significant costs and liabilities for the Company.

Food and Labor Cost Increases

The Company is exposed to numerous cost pressures in the operation of its restaurants including food, fuel and minimum wage increases. To the extent that the business environment prohibits the Company from passing on these increased costs in its selling prices, there could be a material negative impact on the results of operations.

Product and Marketing Success of Franchisors

The Company relies heavily on the success of its franchisors in developing products and marketing programs which support its revenues. Failure of the franchisors to provide appropriate support could have a significant negative impact on the Company s financial performance.

Governmental Laws and Regulations

The operations of the Company are subject to many Federal, state and local regulations governing health, sanitation, workplace safety, public access, wages and benefits among other things. We are also subject to various privacy and security regulations. Changes to any of these regulations can have a significant adverse impact on the operations of the Company.

Quick Service Restaurant Competition

The quick service restaurant industry in which the Company operates is highly competitive and consumers have many choices other than the Company s restaurants. Changes in consumer tastes or preferences could have a significant adverse impact on the operations of the Company.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

The Company leases approximately 6,000 square feet of space for its corporate headquarters in Cleveland, Ohio. The lease expires December 31, 2011 and the rent under the current term is $6,300 per month. The Company also leases space for a regional office in Youngstown, Ohio, which is used to assist in the operation of the KFC, Taco Bell and 2n1 restaurants.

Of the 96 KFC, Taco Bell and 2n1 restaurants, the Company owns the land and building for 56 locations, owns the building and leases the land for 22 locations and leases the land and building for 18 locations. 53 of the owned properties are subject to mortgages. Additionally, the Company leases the land and building for one closed location and owns the land and building for two closed locations which are subject to mortgages, all three of which are leased to an operator of an independent local restaurant concept. Remaining lease terms (including renewal options) range from 1 to 40 years and average approximately 13 years. These leases generally require the Company to pay taxes and utilities, to maintain casualty and liability insurance, and to keep the property in good repair. The Company pays annual rent for each leased KFC, Taco Bell or 2n1 restaurant in amounts ranging from $19,000 to $95,000. In addition, 11 of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for 10 KFC, Taco Bell and 2n1 restaurants exceeded the respective base amounts in fiscal 2008.

The Company believes that its restaurants are generally efficient, well equipped and maintained and in good condition.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

Executive Officers of the Company

The Executive Officers and other Officers of the Company are as follows:

Name	Age	Position with Registrant	Officer Since
Executive Officers:			
Leonard R. Stein-Sapir	69	Chairman of the Board and Chief Executive Officer	April 1989
James J. Liguori	59	President and Chief Operating Officer	June 1979
Kenneth L. Hignett	61	Senior Vice President- Chief Financial Officer & Secretary	May 1989
Other Officers:			
Barton J. Craig	59	Senior Vice President- General Counsel	January 1994
Vincent J. Oddi	65	Vice President- Restaurant Development	September 1979
Ramesh J. Gursahaney	59	Vice President- Operations	January 1991

Officers of the Company serve for a term of one year and until their successors are elected and qualified, unless otherwise specified by the Board of Directors. Any officer is subject to removal with or without cause, at any time, by a vote of a majority of the Board of Directors.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Common Shares are traded over the counter under the symbol MRFD . The following table sets forth, for the periods indicated, the high and low sale prices of the Common Shares as reported.

	Price Range	
	High	Low
Year ended March 2, 2008:		
1st Quarter	$12.90	$11.40
2nd Quarter	12.40	10.95
3rd Quarter	10.99	9.45
4th Quarter	10.95	6.55
Year ended February 25, 2007:		
1st Quarter	$ 5.50	$ 4.50
2nd Quarter	6.15	4.55
3rd Quarter	7.95	4.55
4th Quarter	12.89	7.67

As of May 14, 2008, the Company had approximately 851 shareholders of record. The Company has paid no dividends since fiscal 1975.

Securities authorized for issuance under equity compensation plans are shown in the table below:

Equity Compensation Plan Information as of March 2, 2008

Plan Category	Number of securities to be issued upon exercise of outstanding options	Weighted average exercise price of outstanding options	Number of shares remaining for future issuance under equity compensation plans
Equity Compensation plans approved by security holders	7,500	$ 4.125	149,650
Equity Compensation plans not approved by security holders	62,500	$ 3.00	350
Total	70,000	$ 3.121	150,000

Shareholder Return Performance Graph

Set forth below is a line graph comparing the cumulative total return on the Company s Common Shares, assuming a $100 investment as of March 2, 2003, and based on the market prices at the end of each fiscal year, with the cumulative total return of the Standard & Poor s Midcap 400 Stock Index and a restaurant peer group index composed of 19 restaurant companies each of which has a market capitalization comparable to that of the Company.

Comparison of Cumulative Five Year Total Return

	2003	**2004**	**2005**	**2006**	**2007**	**2008**
MORGANS FOODS INC	**100**	118	54	294	744	385
S&P MIDCAP 400 INDEX	**100**	150	169	199	224	206
RESTAURANT PEER GROUP	**100**	135	148	264	382	378

The companies in the peer group are AM-CH Inc., Avado Brands Inc., Boston Restaurant Assoc. Inc., Brazil Fast Food Corp., Briazz Inc., Chefs International Inc., Creative Host Services Inc., Eateries Inc., Einstein Noah Restaurant Grp, Elmer s Restaurants Inc., Flanigans Enterprises Inc., Good Times Restaurants Inc., Granite City Food & Brewery, Grill Concepts Inc., Health Express USA Inc., Mexican Restaurants Inc., Star Buffet Inc., Tumbleweed Inc. and Western Sizzlin Corp. The restaurant peer group index is weighted based on market capitalization. Some of the companies do not currently exist as independent publicly traded entities but are included in the calculation for the appropriate time periods. The companies included in the peer group index were selected by the Board of Directors.

ITEM 6. SELECTED FINANCIAL DATA

The following selected financial information for each of the five fiscal years in the period ended March 2, 2008, is derived from, and qualified in its entirety by, the consolidated financial statements of the Company. The following selected financial information should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and the notes thereto included elsewhere in this report.

			Years Ended		
$ in thousands	**March 2, 2008**	**February 25, 2007**	**February 26, 2006**	**February 27, 2005**	**February 29, 2004**
Revenues	$ 96,318	$ 91,248	$ 87,457	$ 80,960	$ 81,738
Cost of sales:					
Food, paper and beverage	29,524	27,981	27,146	25,222	24,712
Labor and benefits	27,404	24,798	23,186	22,803	22,816
Restaurant operating expenses	24,415	22,765	22,190	21,015	21,320
Depreciation and amortization	2,953	2,950	3,254	3,419	3,518
General and administrative expenses	6,111	5,428	5,133	4,870	5,574
Loss (gain) on restaurant assets	112	5	(715)	574	567
Operating income	5,799	7,321	7,263	3,057	3,231
Net income (loss)	414	3,527	3,437	(2,141)	(1,579)
Basic net income (loss) per comm. sh. (1)	0.14	1.29	1.26	(0.79)	(0.58)
Diluted net income (loss) per comm. sh. (1)	0.14	1.27	1.24	(0.79)	(0.58)
Working capital (deficiency)	(5,335)	(2,403)	(3,178)	(46,048)	(3,999)
Total assets	55,962	52,323	50,751	48,790	52,672
Long-term debt (less current maturities)	35,789	34,445	37,357		43,370
Long-term capital lease obligations	1,144	1,299	1,194	368	379
Shareholders equity (deficiency)	2,473	1,839	(2,186)	(5,623)	(3,482)

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which were 2,911,448 in 2008, 2,738,982 in 2007, 2,718,495 in 2006, 2,718,495 in

2005 and 2,718,441 in 2004 and the diluted weighted average number of common and common equivalent shares outstanding during each year, which were 2,968,654 in 2008, 2,767,478 in 2007, 2,778,524 in 2006, 2,718,495 in 2005and 2,718,441 in 2004.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

During fiscal 2007 through 2008 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various 2n1 restaurants which include the KFC, Taco Bell, Pizza Hut and A&W concepts in the states of Illinois, Missouri, Ohio, Pennsylvania, West Virginia and New York. The average number of restaurants in operation during each fiscal year was 97 in 2008 and 98 in 2007.

Summary of Expenses and Operating Income as a Percentage of Revenues

	2008	2007
Cost of sales:		
Food, paper and beverage	30.7%	30.7%
Labor and benefits	28.5%	27.2%
Restaurant operating expenses	25.3%	24.9%
Depreciation and amortization	3.1%	3.2%
General and administrative expenses	6.3%	5.9%
Operating income	6.0%	8.0%

Revenues

Revenue was $96,318,000 in fiscal 2008, an increase of $5,070,000, or 5.6%, compared to fiscal 2007. The $5,070,000 increase in restaurant revenues during fiscal 2008 was due mainly to a 3.3% increase in comparable restaurant revenues, $1,830,000 in revenues for the fifty-third week of the Company s 2008 fiscal year and $730,000 of additional revenue from a new restaurant. The revenue increases were partially offset by $534,000 of lost revenues due to restaurants being temporarily closed for remodeling during the Company s very active image enhancement schedule and $635,000 of lost revenue for restaurants permanently closed. The comparable restaurant revenue increase resulted from moderately effective products and promotions from the franchisors.

Revenues for the 17 weeks ended March 2, 2008, were $28,509,000, an increase of $2,687,000 compared to the 16 weeks ended February 25, 2007 primarily resulting from a 3.3% increase in comparable restaurant revenues, $1,830,000 in revenues for the seventeenth week and $434,000 of revenue from a new restaurant. The revenue increases were partially offset by $216,000 of lost revenues due to restaurants being temporarily closed for remodeling during the Company s very active image enhancement schedule and $170,000 of lost revenue for restaurants permanently closed.

Cost of Sales Food, Paper and Beverage

Food, paper and beverage costs were $29,524,000, or 30.7% of revenues, in fiscal year 2008 compared to $27,981,000, or 30.7% of revenues, in fiscal year 2007. These results were comparable to the prior year as a percentage of revenues but included significant food waste due to the opening and closing of restaurants for remodeling and higher commodity costs offset by increased efficiency due to higher average restaurant volumes.

For the fourth quarter of fiscal 2008, food, paper and beverage costs increased as a percentage of revenues to 30.9% from 30.0% in the fourth quarter fiscal 2007. The increase of 0.9% was primarily caused by inefficiencies due to the opening and closing of restaurants for remodeling and rising commodity prices.

Cost of Sales Labor and Benefits

Labor and benefits increased to 28.5% of revenues or $27,404,000 in fiscal 2008 from 27.2% of revenues or $24,798,000 in fiscal 2007 due to minimum wage increases in the Company s markets as well as labor expended in the Company s aggressive image enhancement program.

Labor and benefit costs for the fourth quarter of fiscal 2008 increased to 30.9% of revenues or $8,801,000 compared to 29.7% of revenues or $7,668,000 in fiscal 2007. This percentage increase was primarily the result of minimum wage increases, higher benefit costs and labor expended in the Company s aggressive image enhancement program.

Restaurant Operating Expenses

Restaurant operating expenses increased to 25.3% as a percentage of revenues or $24,415,000 in fiscal 2008 from 24.9% of revenues or $22,765,000 in fiscal 2007. The increase was primarily caused by higher utilities, trash removal and outside services.

Restaurant operating expenses for the fourth quarter of fiscal 2008 increased as a percentage of revenues to 26.0% or $7,399,000 from 25.7% of revenues or $6,626,000 in the year earlier quarter. This increase was primarily the result of higher utility costs.

Depreciation and Amortization

Depreciation and amortization for fiscal 2008 at $2,953,000 was similar to fiscal 2007 at $2,950,000; this result was caused by reductions due to assets becoming fully depreciated, offset by the addition of new assets from the Company s image enhancement program.

Depreciation and amortization for the fourth quarter of fiscal 2008 was $960,000 compared to $869,000 for the fourth quarter of fiscal 2007. The increase was primarily due to $56,000 of additional expense in the current fiscal quarter from the period containing 17 weeks instead of 16 for the prior year quarter as well as higher depreciation from the increased capital expenditures in the current year.

General and Administrative Expenses

General and administrative expenses increased to $6,111,000, or 6.3% of revenues, in fiscal 2008 from $5,428,000, or 5.9% of revenues, in fiscal 2007 primarily as a result of increases in officers salary expense, field administrative salaries expense, bank service charges and health and welfare expense.

For the fourth quarter of fiscal 2008, general and administrative expenses increased to $1,838,000, or 6.4% of revenues, from $1,761,000 or 6.8% of revenues in the fourth quarter of fiscal 2007 primarily because of the extra week in the 2008 period due to the Company s 53 week year.

Loss on Restaurant Assets

The Company had a loss on restaurant assets of $112,000 in fiscal 2008 compared to $5,000 in fiscal 2007. The fiscal 2008 loss primarily reflects assets disposed of during image enhancement of the Company s restaurants and a $5,000 charge for asset impairment writedowns.

In the fourth quarter of fiscal 2008 the Company had a loss on restaurant assets of $36,000 compared to $9,000 in the fourth quarter of fiscal 2007 primarily for assets disposed during image enhancement activities.

Operating Income

Operating income in fiscal 2008 decreased to $5,799,000 from $7,321,000 in fiscal 2007 primarily as a result of the items discussed above.

Interest Expense

Prepayment and Deferred Financing Costs

During the fourth quarter of fiscal 2008 the Company completed the funding of two loan agreements totaling $12,600,000, the proceeds of which were used to retire $10,901,000 of debt before its scheduled maturity. This transaction is described in more detail in Note 5 to the consolidated financial statements. As a result of the early payment, the Company was required to pay prepayment penalties and administrative fees of $1,718,000 and write off $154,000 of deferred financing costs remaining from the origination of the loans in fiscal 2000. The deferred financing costs are a non-cash charge.

Bank and Capitalized Lease Interest Expense

Interest expense on bank debt and notes payable decreased to $3,472,000 in fiscal 2008 from $3,762,000 in fiscal 2007. The decrease in interest expense for fiscal 2008 was the result of principal payments which reduced the outstanding debt balances. Interest expense from capitalized lease debt increased slightly to $125,000 in fiscal 2008 from $117,000 in fiscal 2007 as a result of the addition of a capitalized lease during the 2008 fiscal year.

Other Income

Other income increased to $433,000 in fiscal 2008 compared to $221,000 in fiscal 2007 primarily due to $230,000 of income earned on temporary investment of available cash balances.

Provision for Income Taxes

The current tax provision consists of federal tax of $47,000 for fiscal 2007 and state and local taxes for fiscal 2008 and 2007 of $14,000 and $117,000, respectively. The deferred tax provision for fiscal 2008 and 2007 is $335,000 and a benefit of $(28,000), respectively, and resulted from a change in the valuation allowance for deferred tax assets offset by an increase in deferred tax liabilities associated with indefinite lived intangible assets for book purposes.

Liquidity and Capital Resources

Cash flow activity for fiscal 2008 and 2007 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was $4,856,000 for the year ended March 2, 2008 compared to $7,114,000 for the year ended February 25, 2007. The decrease in operating cash flow was primarily the result of lower net income partially offset by increases in accounts payable due to longer food vendor payment terms during fiscal 2008. The Company paid long-term bank debt of $13,691,000 in fiscal 2008, including the refinancing of approximately $10,901,000 of existing debt, compared to payments of $3,115,000 in fiscal 2007. Proceeds from the issuance of long-term debt were $15,312,000 during fiscal 2008. Proceeds from stock option exercises were $220,000 in fiscal 2008 compared to $498,000 in fiscal 2007. Capital expenditures in fiscal 2008 were $8,215,000 compared to $2,970,000 in fiscal 2007. This increase is primarily a result of the image enhancement of twenty restaurants and the building of one new KFC/Taco Bell 2n1 which replaced an existing Taco Bell restaurant.

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. Certain loans also require a funded debt (debt balance plus a calculation based on operating lease payments) to earnings before interest, taxes, depreciation, amortization and rent ratio of 5.5 or less. 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. The consolidated and individual coverage ratios are computed quarterly. At the end of fiscal 2008, the Company was in compliance with the consolidated fixed charge coverage ratio of 1.2. However, at the end of fiscal 2008 the Company was not in compliance with the individual fixed charge coverage ratio on 21 of its restaurant properties and has obtained waivers with respect to the non-compliance.

Subsequent Events

On May 30, 2008, subsequent to its fiscal year end of March 2, 2008, the Company completed a set of financing transactions involving: 1) the sale leaseback of five of its restaurant properties, 2) equipment debt supported by five additional restaurants and 3) the payment, before their maturity, of nine existing loans secured by certain of the properties. The Company retired approximately $1,532,000 of debt, paid $222,000 of prepayment charges and administrative fees and will write off approximately $31,000 of deferred financing costs associated with the loans being retired early. The Company received approximately $5,182,000 of proceeds from the sale leasebacks, net of origination fees and costs, and approximately $2,970,000 of net proceeds from the equipment loan. The leases are structured as operating leases and have a primary term of 18 years and with annual rent ranging approximately $448,000 to $577,000. The loan has a variable rate based on a spread over LIBOR, a term of five years and an amortization of ten years. The Company will use the proceeds of the transactions for general corporate purposes, including funding of its image enhancement program. No effects of this transaction are included in the Company s financial statements for the fiscal year ended March 2, 2008.

Market Risk Exposure

Certain of the Company s debt comprising approximately $12.6 million of principal balance has a variable rate which is adjusted monthly. A one percent increase in variable rate base (90 day LIBOR) of the loans at the beginning of the year would cost the Company approximately $124,000 in additional annual interest costs. The Company may choose to offset all, or a portion of the risk through the use of interest rate swaps. The Company s remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company s financial position, liquidity or results of operations.

Required Capital Expenditures

The Company is required by its franchise agreements to periodically bring its restaurants up to 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)**
5	Fiscal 2009	IE	1,760,000	1,560,000	200,000
1	Fiscal 2009	Rebuild	450,000	450,000	
1	Fiscal 2009	Relo (4)	400,000	400,000	
1	Fiscal 2010	IE	750,000	750,000	
18	Fiscal 2011	IE	6,400,000	5,680,000	720,000
1	Fiscal 2011	Relo (4)	1,400,000	1,400,000	
1	Fiscal 2012	Relo (4)	1,400,000	1,400,000	
0	Fiscal 2013	IE			
1	Fiscal 2014	Rebuild	1,000,000	1,000,000	
4	Fiscal 2015	Relo (4)	4,000,000	4,000,000	
1	Fiscal 2016	Relo (4)	500,000	500,000	
0	Fiscal 2017-2019	IE			
5	Fiscal 2020	Relo (4)	7,000,000	7,000,000	
2	Fiscal 2020	Rebuild	2,000,000	2,000,000	
41	Total		$27,060,000	$26,140,000	$920,000

(1) These amounts are based on 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.

Seasonality

The operations of the Company are affected by seasonal fluctuations. Historically, the Company s revenues and income have been highest during the summer months with the fourth fiscal quarter representing the slowest period. This seasonality is primarily attributable to weather conditions in the Company s marketplace, which consists of portions of Ohio, Pennsylvania, Missouri, Illinois, West Virginia and New York. Also, the fourth fiscal quarter the only two holidays for which the Company s restaurants are closed, contributing to lower sales in the period.

Critical Accounting Policies

The Company s reported results are impacted by the application of certain accounting policies that require it to make subjective or complex judgments or to apply complex accounting requirements. These judgments include estimations about the effect of matters that are inherently uncertain and may significantly impact its quarterly or annual results of operations, financial condition or cash flows. Changes in the estimates and judgments could significantly affect results of operations, financial condition and cash flows in future years. The Company believes that its critical accounting policies are as follows:

- Estimating future cash flows and fair value of assets associated with assessing potential impairment of long-lived tangible and intangible assets and projected compliance with debt covenants.

- Determining the appropriate valuation allowances for deferred tax assets and reserves for potential tax exposures. See Note 8 to the consolidated financial statements for a discussion of income taxes.

- Applying complex lease accounting requirements to the Company s capital and operating leases of property and equipment. The Company leases the building or land, or both, for nearly one-half of its restaurants. See Note 6 to the consolidated financial statements for a discussion of lease accounting.

New Accounting Standards

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles and expands disclosures about fair value measurements. The provisions of SFAS No. 157 apply under other accounting pronouncements that require or permit fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those years for financial assets and liabilities, and for fiscal years beginning after November 15, 2008 for nonfinancial assets and liabilities. The Company does not believe that adoption of SFAS No. 157 will have a material impact on its financial position, results of operations or related disclosures.

In February 2007, the FASB issued SFAS No. 159 The Fair Value Option for Financial Assets and Financial Liabilities (SFAS 159). SFAS 159 provides companies with an option to report selected financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. SFAS 159 is effective for fiscal years beginning after November 15, 2007, the year beginning March 3, 2008 for the Company. We are currently reviewing the provisions of SFAS 159 to determine any impact for the Company.

In March 2008, the FASB issued SFAS No. 161 Disclosure About Derivative Instruments and Hedging Activities-an amendment to FASB Statement 133 (SFAS 161). SFAS 161 requires enhanced disclosures about derivatives and hedging activities and the reasons for using them. SFAS 161 is effective for fiscal years beginning after November 15, 2008, the year beginning March 2, 2009 for the Company. We are currently reviewing the provisions of SFAS 161 to determine any impact for the Company.

In December 2007, the FASB issued SFAS 141R Business Combinations. SFAS No. 141R modifies the accounting for business combinations by requiring that acquired assets and assumed liabilities be recorded at fair value, contingent consideration arrangements be recorded at fair value on the date of the acquisition and preacquisition contingencies will generally be accounted for in purchase accounting at fair value. The pronouncement also requires that transaction costs be expensed as incurred, acquired research and development be capitalized as an indefinite-lived intangible asset and the requirements of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities be met at the acquisition date in order to accrue for a restructuring plan in purchase accounting. SFAS No. 141R is required to be adopted prospectively effective for fiscal years beginning after December15, 2008.

Safe Harbor Statements

Portions of this document contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Such statements include those identified by such words as may, will, expect anticipate, believe, plan and other similar termino
The forward-looking statements reflect the Company s current expectations, are based upon data available at the time of the statements and are subject to risks and uncertainties that could cause actual results or events to differ materially from those expressed in or implied by such statements. Such risks and uncertainties include both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations, its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1.A.(Risk Factors).

Economic and industry risks and uncertainties include, but are not limited, to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Certain of the Company s debt comprising approximately $12.6 million of principal balance has a variable rate which is adjusted monthly. A one percent increase in the variable rate base (90 day LIBOR) of the loans at the beginning of the year would cost the Company approximately $124,000 in additional annual interest costs. The Company may choose to offset all, or a portion, of the risk through the use of interest rate swaps. The Company s remaining borrowings are at fixed interest rates, and accordingly the Company does not have market risk exposure for fluctuations in interest rates relative to those loans. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company s financial position, liquidity or results of operations.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

MORGAN S FOODS, INC.

INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULES

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders of
Morgan s Foods, Inc.

We have audited the accompanying consolidated balance sheets of Morgan s Foods, Inc. (an Ohio corporation) and subsidiaries (the Company) as of March 2, 2008 and February 25, 2007, and the related consolidated statements of operations, shareholders equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Morgan s Foods, Inc. and subsidiaries as of March 2, 2008 and February 25, 2007, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

/s/ GRANT THORNTON LLP
Cleveland, Ohio
May 30, 2008

MORGAN S FOODS, INC.
Consolidated Balance Sheets
Years Ended March 2, 2008 and February 25, 2007

	2008	**2007**
ASSETS		
Current assets:		
Cash and equivalents	$ 6,428,000	$ 7,829,000
Receivables	423,000	345,000
Inventories	755,000	684,000
Prepaid expenses	679,000	600,000