MEXICAN RESTAURANTS INC
Form 10-Q
August 02, 2002

UNITED STATES

SECURITIES & EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(MARK ONE)

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

For the Quarterly period ended JUNE 30, 2002

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 X No

Number of shares outstanding of each of the issuer's classes of common stock, as of July 22, 2002: 3,425,605 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) 6/30/2002
Current assets:	
Cash and cash equivalents	$ 319,427
Royalties receivable	128,856
Other receivables	567,070
Inventory	591,425
Taxes receivable	192,174
Prepaid expenses and other current assets	623,432
Total current assets	2,422,384
Property, plant and equipment	26,363,001
Less accumulated depreciation	(9,758,836)
Net property, plant and equipment	16,604,165
Deferred tax assets	906,855
Property held for resale	958,487
Other assets	8,460,236
	$ 29,352,127
LIABILITIES AND STOCKHOLDERS' EQUITY	
Current liabilities:	
Current installments of long-term debt	$ 1,000,000
Accounts payable	1,930,163
Accrued sales and liquor taxes	483,704
Accrued payroll and taxes	928,724
Accrued expenses	818,316
Total current liabilities	5,160,907
Long-term debt, net of current portion	4,622,729
Other liabilities	816,053
Deferred gain	2,289,569
Stockholders' equity:	
Preferred stock, $.01 par value, 1,000,000 shares authorized	--
Capital stock, $0.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued	47,327
Additional paid-in capital	20,121,076
Retained earnings	7,965,672
Deferred compensation	(109,563)
Treasury stock, cost of 1,181,600 and 1,191,000 shares, respectively	(11,561,643)
Total stockholders' equity	16,462,869
	$ 29,352,127

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME
(UNAUDITED)

	13-WEEK PERIOD ENDED 06/30/02	13-WEEK PERIOD ENDED 07/01/01	26-WEEK PERIOD ENDED 06/30/02
Revenues:			
Restaurant sales	$ 15,252,133	$ 15,520,414	$ 30,237,031
Franchise fees and royalties	307,913	299,995	622,843
Other	11,233	64,993	17,658
	15,571,279	15,885,402	30,877,532
Costs and expenses:			
Cost of sales	4,198,866	4,300,098	8,245,060
Labor	5,000,758	5,104,894	9,882,310
Restaurant operating expenses	3,656,919	3,981,999	7,314,637
General and administrative	1,275,223	1,363,345	2,622,979
Depreciation and amortization	554,635	576,417	1,097,051
Pre-opening costs	--	--	--
	14,686,401	15,326,753	29,162,037
Operating income	884,878	558,649	1,715,495
Other income (expense):			
Interest income	17,330	3,372	27,172
Interest expense	(84,625)	(219,116)	(203,949)
Other, net	7,410	245,040	29,379
	(59,885)	29,296	(147,398)
Income before income tax expense	824,993	587,945	1,568,097
Income tax expense	230,998	205,710	476,222
Net income	$ 593,995	$ 382,235	$ 1,091,875
Basic income per share	$ 0.17	$ 0.11	$ 0.31
Diluted income per share	$ 0.17	$ 0.11	$ 0.31
Weighted average number of shares (basic)	3,470,851	3,530,718	3,487,840
Weighted average number of shares (diluted)	3,581,074	3,530,718	3,569,353

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MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

26-WEEK PERIODS EN

	6/30/2002	7
Cash flows from operating activities:		
Net income	$ 1,091,875	$
Adjustments to reconcile net income to net cash provided by operating activities:		
Deferred compensation	20,652	
Depreciation and amortization	1,097,051	1
Deferred gain amortization	(104,070)	
Deferred taxes	238,505	
Loss (gain) on sale of property, plant & equipment	10,182	
Changes in assets and liabilities:		
Royalties receivable	(15,527)	
Other receivables	29,616	
Income tax receivable/payable	140,864	
Inventory	62,812	
Prepaid and other current assets	25,727	
Other assets	(5,572)	
Accounts payable	(17,810)	
Accrued expenses and other liabilites	(623,620)	
Other liabilities	201,837	
Total adjustments	1,060,647	
Net cash provided by operating activities	2,152,522	1
Cash flows from investing activities:		
Purchase of property, plant and equipment	(915,743)	(1
Proceeds from sale of property, plant and equipment	78,000	
Payment received on note for sale of property	10,096	
Net cash used in investing activities	(827,647)	(1
Cash flows from financing activities:		
Net borrowings (payments) under line of credit	(950,000)	
Purchase of treasury stock	(366,871)	
Net cash used in financing activities	(1,316,871)	
Increase (decrease) in cash and cash equivalents	8,004	
Cash and cash equivalents at beginning of period	311,423	
Cash and cash equivalents at end of period	$ 319,427	$
Supplemental disclosure of cash flow information:		
Cash paid during the period:		
Interest	$ 182,912	$
Income Taxes	$ 106,615	$
Non-cash investing and financing activity:		
Sale of property for note receivable	$ 398,047	$

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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 June 30, 2002, and the consolidated statements of income and cash flows for the 26-week and 13-week periods ended June 30, 2002 and July 1, 2001. The consolidated statements of income for the 26-week and 13-week period ended June 30, 2002 is not necessarily indicative of the results to be expected for the full year.

IMPACT OF RECENTLY ISSUED ACCOUNTING STANDARDS

In July 2001, the FASB issued Statement on Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets," (SFAS 142) which became effective for our Company the beginning of fiscal 2002. SFAS 142 requires goodwill and other intangible assets with indefinite lives no longer be amortized. SFAS 142 further requires the fair value of goodwill and other intangible assets with indefinite lives be tested for impairment upon adoption of this statement, annually and upon the occurrence of certain events, and be written down to fair value if considered impaired. The adoption of SFAS 142 resulted in the elimination of annual amortization expense related to goodwill in the amount of approximately $329,468. If SFAS had been adopted in fiscal 2001, adjusted net income for the second quarter and the 26-week period would have been $435,774 and $873,955, or $0.12 and $0.24 per share, respectively. Our management has evaluated goodwill as required by SFAS 142 and has determined that no impairment of goodwill exists.

In August, 2001, the FASB issued Statement on Financial Accounting Standards No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets," (SFAS 144) which became effective for our Company the beginning of fiscal 2002. SFAS 144 requires that long-lived assets to be disposed of by sale be measured at the lower of carrying amount or fair value less cost to sell, whether reported in continuing operations or in discontinued operations. SFAS 144 broadens the reporting of discontinued operations to include all components of an entity with operations that can be distinguished from the rest of the entity and that will be eliminated from the ongoing operations of the entity in a disposal transaction. There has been no impact on our financial position or results of operations due to the adoption of SFAS 144.

SFAS No. 145, "Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13 and Technical Corrections," was issued in April 2002. SFAS No. 145 provides guidance for income statement classification of gains and losses on extinguishment of debt and accounting for certain lease modifications that have economic effects that are similar to sale-leaseback transactions. SFAS No. 145 is effective for the Company in January 2003. The Company is evaluating the impact of SFAS No. 145.

SFAS No. 146, "Accounting for Exit or Disposal Activities" was issued in June 2002. SFAS No. 146 addresses significant issues regarding the recognition, measurement, and reporting of costs that are associated with exit and disposal activities, including restructuring activities that are currently accounted for pursuant to the guidance set forth in EITF Issue No. 94-3, "Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity." SFAS No. 146 is effective for the Company in January 2003. The Company is evaluating the impact of SFAS No. 146.

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 (LOSS) PER COMMON SHARE

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 June 30, 2002 and July 1, 2001, the Company had 1,066,770 and 900,170 options and warrants outstanding, respectively. As of June 30, 2002 and July 1, 2001, such stock options and warrants have the effect of increasing basic weighted average shares outstanding by 110,223 and 0 for the 13-week periods and by 81,513 and 0 for the 26-week periods, respectively.

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: accelerating 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 30, 2001, 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 second quarter of fiscal year 2002 were down $314,123 or 2.0% to $15.6 million compared with the same quarter one year ago. Restaurant sales for the second quarter of fiscal year 2002 were down $268,281 compared with the same quarter one year ago, to $15.3 million. The decline reflects the December 30, 2001 closure of three under-performing restaurants in Boise, Idaho. In the fiscal quarter ended July 1, 2001, the three restaurants located in Boise, Idaho accounted for $417,511 in restaurant sales. Towards the end of the second quarter of fiscal year 2001, in addition to the three restaurants that were closed, one restaurant was acquired from a franchisee. Total system sales at restaurants operating in both fiscal quarters ("same-stores") increased 1.4%. Company-owned same-store sales for the quarter decreased 0.9%. Franchise-owned same-store sales for the quarter increased 4.4%.

On a year-to-date basis, the Company's revenues were down $785,871 or 2.5% to $30.9 million compared with the same 26-week period one year ago. Restaurant sales were down $734,404 or 2.4% compared with the same 26-week period one year ago. The decrease was due to the same factors discussed above. Year-to-date total system same-store sales increased 1.8%. Company-owned same-store sales for the 26-week period decreased 1.1%. Franchise-owned same-store sales for the 26-week period increased 5.7%.

Costs and Expenses. Cost of sales, consisting primarily of food and beverage costs, but also including paper and supplies, decreased as a percentage of restaurant sales in the second quarter of fiscal 2002 to 27.5% as compared with 27.7% in the same quarter in fiscal 2001. While a small portion of the improvement was due to the closure of under-performing restaurants, most of the improvement was the result of buying efficiencies.

On a year-to-date basis, cost of sales decreased as a percentage of restaurant sales to 27.3% as compared with 27.6% in the same quarter in fiscal 2001. The decrease was due to the same factors discussed above.

Labor and other related expenses decreased as a percentage of restaurant sales to 32.8% in the second quarter of fiscal 2002 as compared with 32.9% in the same quarter in fiscal 2001. While a small portion of the improvement was due to the closure of under-performing restaurants, most of the improvement was the result of labor efficiencies gained through increased same-store sales at Casa Ole and La Senorita.

On a year-to-date basis, labor and other related expenses decreased as a percentage of restaurant sales to 32.7% in the 26-week period ended June 30, 2002 compared with 33.0% in the same 26-week period one year ago. The decrease was primarily due to the same factors discussed above.

Restaurant operating expenses, which primarily includes rent, property taxes, utilities, repair and maintenance, liquor taxes and advertising, decreased as a percentage of restaurant sales to 24.0% in the second quarter of fiscal 2002 as compared with 25.7% in the same quarter in fiscal 2001. The improvement reflects lower utility and occupancy expenses.

On a year-to-date basis, restaurant operating expenses decreased as a percentage of restaurant sales to 24.2% in the 26-week period ended June 30, 2002 compared with 25.1% in the same 26-week period one year ago. The decrease was primarily due to the same factors discussed above.

General and administrative expenses decreased as a percentage of total sales to 8.2% in the second quarter of fiscal 2002 as compared with 8.6% in the same quarter in fiscal year 2001. During the second quarter in fiscal 2001, the Company accrued $100,000 in severance. Without the severance, general and administrative expense, as a percentage of total sales, for second quarter in fiscal 2001 would have been 8.0%.

On a year-to-date basis, general and administrative expenses increased as a percentage of total sales 10 basis points to 8.5% in the 26-week period ended June 30, 2002 compared with 8.4% in the

same 26-week period one year ago. The increase reflects a lower revenue base as the Company closed under-performing restaurants.

Depreciation and amortization expense did not change as a percentage of total sales, remaining at 3.6% in the second quarter of fiscal 2002 compared with 3.6% the same quarter in fiscal 2001. In fiscal year 2002, the Company adopted SFAS 142, "Goodwill and Other Intangible Assets," which requires goodwill and other intangible assets with indefinite lives no longer be amortized. During the second quarter of fiscal year 2001, amortization expense was $82,367.

On a year-to-date basis, depreciation and amortization expense also did not change as a percentage of total sales, remaining at 3.6% for the 26-week period ended June 30, 2002 compared with 3.6% the same 26-week period one year ago. For the 26-week period ended July 1, 2001, amortization expense was $164,734.

The Company did not open any new restaurants in the first or second quarters of 2002; consequently, there were no pre-opening costs.

Other Income (Expense). Net other income (expense) decreased from income to an expense by $89,181 compare with the second quarter in fiscal 2001. The decrease was due to last year's $226,000 gain on sale of one restaurant. For the second quarter of fiscal 2002, interest expense decreased by $134,491 compared with the second quarter in fiscal 2001. The decrease reflects a decline in debt outstanding and a decline in interest rates. Total debt as of June 30, 2002 was $5.6 million compared with $7.8 million as of July 1, 2001.

On a year-to-date basis, net other income (expense) increased in expense by $5,384 due to the factors discussed above.

Income Tax Expense. For the second quarter of fiscal 2002, the Company's effective tax rate was 28.0% as compared with 35.0% in the same quarter in fiscal 2001. The decrease was due to the utilization of tax credit carryforwards and the adjustment of tax basis assets related to previous acquisitions.

On a year-to-date basis, the Company's effective tax rate was 30.0% compared with 35.0% in the same 26-week period one year ago. The decrease was due to the utilization of tax credit carryforwards and the adjustment of tax basis assets related to previous acquisitions.

LIQUIDITY AND CAPITAL RESOURCES

The Company met capital requirements for the 26-week period ended June 30, 2002 with cash generated by operations. As of June 30, 2002, the Company's operations generated approximately $2,152,522 in cash, as compared with $1,446,135 in the 26-week period one year ago. As of June 30, 2002, the Company had a working capital deficit of approximately $2.7 million. 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 new restaurant development or acquisitions and remodeling of older units. During the 26-week period of fiscal 2002, capital expenditures on property, plant and equipment were approximately $915,743 as compared to $1,117,274 for the 26-week period of fiscal 2001. Capital expenditures included the remodeling of four restaurants. The Company also sold a previously closed restaurant for $78,000 in cash and a note for $400,000, for a total of $478,000. Additionally, the Company had cash outlays for necessary replacement of equipment and leasehold improvements in various older units. There are no new restaurants planned for fiscal year 2002. The Company does plan to modestly remodel one more

restaurant in fiscal year 2002. The Company estimates its capital expenditures for the remainder of the fiscal year will be approximately $800,000.

On July 9, 2002, a fire damaged and closed a Company-leased restaurant. The restaurant, which was insured for both property damage and business interruption, will likely be closed for approximately 120 days, and the Company does not expect any material losses as a result of this fire.

On June 29, 2001, the Company re-financed $7.8 million of its debt with Fleet National Bank. The new credit facility is for $10.0 million. The credit facility consists of a $5.0 million term note that requires quarterly principal payments of $250,000 and matures on June 29, 2006. The credit facility also includes 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. As of June 30, 2002, the Company had $5.6 million outstanding on the credit facility and is in full compliance with all debt covenants. Over the last several years, the Company's debt was incurred to acquire Monterey's Acquisition Corp, which was acquired on July 1997, La Senorita Restaurants, which was acquired on April 30, 1999, to develop new restaurants, to remodel existing restaurants, as well as to accommodate other working capital needs. The Company paid down debt

$950,000 during the 26-week period of fiscal 2002, and anticipates that it will use excess cash flow during the remainder of fiscal 2002 to pay down debt approximately $1.0 million more (a total of $2.0 million for fiscal year 2002). During the second quarter of fiscal 2002, the Company's Board of Directors authorized management to implement a limited stock repurchase program in the amount of $350,000. The stock repurchase program was substantially completed during the second quarter with the acquisition of 78,500 common shares for $337,731, or $4.30 per share. The Company also purchased 11,175 vested options for $13,400 and 9,400 common shares for $40,068 from former employees and a former director of the Company. The shares acquired are being held for general corporate purposes, including the offset of the dilutive effect on shareholders from the exercise of stock options.

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 2002 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 in the previous paragraph.

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 June 30, 2002, a 1% change in interest rates would change interest expense by $14,000.

PART II - OTHER INFORMATION

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

(A) EXHIBITS

Exhibit Number	Document Description
99.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
99.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section

906 of the Sarbanes-Oxley Act of 2002

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.

MEXICAN RESTAURANTS, INC.

Dated: August 2, 2002 By: /s/ Curt Glowacki

Curt Glowacki
Chief Executive Officer
(Principal Executive Officer)

Dated: August 2, 2002 By: /s/ Andrew J. Dennard

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

INDEX TO EXHIBITS

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