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MORGANS FOODS INC
Form 10-Q
September 26, 2001

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the period ended August 12, 2001

Commission file number 0-3833

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)

24200 Chagrin Boulevard, Suite 126, Beachwood, Ohio

44122

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code:

(216) 360-7500

(Former name, former address and former fiscal year,
if changed since last report)

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

As of September 21, 2001, the issuer had 2,795,341 shares of common stock outstanding.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Morgan's Foods, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	AUGUST 1
REVENUES.....	\$ 19,
COST OF SALES:	
FOOD, PAPER AND BEVERAGE.....	6,
LABOR AND BENEFITS	5,
RESTAURANT OPERATING EXPENSES	5,
DEPRECIATION AND AMORTIZATION	
GENERAL AND ADMINISTRATIVE EXPENSES.....	1,
LOSS ON RESTAURANT ASSETS.....	
OPERATING INCOME.....	1,
INTEREST EXPENSE:	
BANK DEBT AND NOTES PAYABLE.....	(1,
CAPITAL LEASES.....	
OTHER INCOME AND EXPENSE, NET.....	
INCOME BEFORE INCOME TAXES	
PROVISION FOR INCOME TAXES.....	
NET INCOME.....	\$
BASIC NET INCOME PER COMMON SHARE.....	\$
DILUTED NET INCOME PER COMMON SHARE.....	\$
BASIC WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING.....	2,
DILUTED WEIGHTED AVERAGE NUMBER OF SHARES OUTSTANDING.....	2,

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements.

Morgan's Foods, Inc.

CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited)

	AUGUST 1
REVENUES.....	\$ 38,
COST OF SALES:	
FOOD, PAPER AND BEVERAGE.....	11,
LABOR AND BENEFITS	10,
RESTAURANT OPERATING EXPENSES	9,
DEPRECIATION AND AMORTIZATION	1,
GENERAL AND ADMINISTRATIVE EXPENSES.....	2,
LOSS ON RESTAURANT ASSETS.....	
OPERATING INCOME.....	2,
INTEREST EXPENSE:	
BANK DEBT AND NOTES PAYABLE.....	(2,
CAPITAL LEASES.....	
OTHER INCOME AND EXPENSE, NET.....	
INCOME (LOSS) BEFORE INCOME TAXES	
PROVISION FOR INCOME TAXES.....	
NET INCOME (LOSS).....	\$
BASIC NET INCOME (LOSS) PER COMMON SHARE.....	\$
DILUTED NET INCOME (LOSS) PER COMMON SHARE.....	\$
BASIC WEIGHTED AVERAGE NUMBER OF	
SHARES OUTSTANDING.....	2,
DILUTED WEIGHTED AVERAGE NUMBER OF	
SHARES OUTSTANDING.....	2,

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Morgan's Foods, Inc.

CONSOLIDATED BALANCE SHEETS

(unaudited)

	AUGUST 12, 2001	FEBRUARY 28, 2001
	-----	-----
ASSETS		
CURRENT ASSETS:		
CASH AND EQUIVALENTS.....	\$ 6,685,000	\$
RECEIVABLES.....	38,000	
INVENTORIES.....	479,000	
PREPAID EXPENSES.....	326,000	
	-----	-----
	7,528,000	
PROPERTY AND EQUIPMENT:		
LAND.....	10,801,000	
BUILDINGS AND IMPROVEMENTS.....	17,829,000	
PROPERTY UNDER CAPITAL LEASES.....	1,006,000	
LEASEHOLD IMPROVEMENTS.....	7,312,000	
EQUIPMENT, FURNITURE AND FIXTURES.....	17,830,000	
CONSTRUCTION IN PROGRESS.....	118,000	
	-----	-----
	54,896,000	
LESS ACCUMULATED DEPRECIATION AND AMORTIZATION.....	15,581,000	
	-----	-----
	39,315,000	
OTHER ASSETS:		
FRANCHISE AGREEMENTS.....	1,553,000	
DEFERRED TAXES.....	2,186,000	
	600,000	
ACQUIRED FRANCHISE RIGHTS.....	9,661,000	
	-----	-----
	\$ 60,843,000	\$
	=====	=====
LIABILITIES AND SHAREHOLDERS' DEFICIENCY		
CURRENT LIABILITIES:		
CURRENT MATURITIES OF LONG-TERM DEBT.....	\$ 2,182,000	\$
CURRENT MATURITIES OF CAPITAL LEASE OBLIGATIONS	106,000	
ACCOUNTS PAYABLE.....	3,661,000	
ACCRUED LIABILITIES.....	3,267,000	
	-----	-----
	9,216,000	
LONG-TERM DEBT	49,924,000	
LONG-TERM CAPITAL LEASE OBLIGATIONS	595,000	
OTHER LONG-TERM LIABILITIES	1,335,000	
SHAREHOLDERS' DEFICIENCY		
PREFERRED SHARES, 1,000,000 SHARES AUTHORIZED, NO SHARES OUTSTANDING		
COMMON STOCK		
AUTHORIZED SHARES - 25,000,000		
ISSUED SHARES - 2,969,405.....	30,000	
TREASURY STOCK - 73,730 IN 2001 AND 31,833 IN 2000.....	(64,000)	
CAPITAL IN EXCESS OF STATED VALUE.....	28,844,000	
ACCUMULATED DEFICIT.....	(29,037,000)	

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TOTAL SHAREHOLDERS' DEFICIENCY.....	(227,000)	
	\$ 60,843,000	\$

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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Morgan's Foods, Inc.

CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (DEFICIENCY)

(unaudited)

	COMMON SHARES		TREASURY SHARES		CAPITAL EXCESS STATE
	SHARES	AMOUNT	SHARES	AMOUNT	
Balance, February 27, 2000.....	2,969,405	\$30,000	(46,678)	\$(111,000)	\$28,87
Net loss.....	-	-	-	-	
Issue of treasury shares for 401(k) contributions.....	-	-	14,845	35,000	
Balance, February 25, 2001.....	2,969,405	30,000	(31,833)	(76,000)	28,87
Net income.....	-	-	-	-	
Purchase of common shares.....	-	-	(73,730)	(64,000)	
Issue of treasury shares for 401(k) contributions.....	-	-	31,833	76,000	(31
Balance, August 12, 2001.....	2,969,405	\$ 30,000	(73,730)	\$(64,000)	\$28,844

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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Morgan's Foods, Inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited)

AUGUST 12,

CASH FLOWS FROM OPERATING ACTIVITIES:

NET INCOME (LOSS).....	\$
ADJUSTMENTS TO RECONCILE TO NET CASH	
PROVIDED BY OPERATING ACTIVITIES:	
DEPRECIATION AND AMORTIZATION.....	
AMORTIZATION OF SUPPLY AGREEMENT ADVANCES.....	
FUNDING FROM SUPPLY AGREEMENTS.....	
LOSS ON RESTAURANT ASSETS.....	
CHANGE IN ASSETS AND LIABILITIES:	
DECREASE IN RECEIVABLES.....	
DECREASE (INCREASE) IN INVENTORIES.....	
DECREASE (INCREASE) IN PREPAID EXPENSES.....	
DECREASE IN OTHER ASSETS.....	
INCREASE (DECREASE) IN ACCOUNTS PAYABLE.....	
INCREASE IN ACCRUED LIABILITIES.....	
NET CASH PROVIDED BY OPERATING ACTIVITIES.....	-----

CASH FLOWS FROM INVESTING ACTIVITIES:

CAPITAL EXPENDITURES.....	
PURCHASE OF FRANCHISE AGREEMENTS AND	
ACQUIRED FRANCHISE RIGHTS.....	
PROCEEDS FROM SALE OF RESTAURANT ASSETS.....	
NET CASH USED IN INVESTING ACTIVITIES.....	-----

CASH FLOWS FROM FINANCING ACTIVITIES:

PROCEEDS FROM ISSUANCE OF LONG-TERM DEBT,	
NET OF FINANCING COSTS.....	
PRINCIPAL PAYMENTS ON LONG-TERM DEBT.....	
PRINCIPAL PAYMENTS ON CAPITAL LEASE OBLIGATIONS.....	
PURCHASE OF TREASURY SHARES.....	
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES.....	-----

NET CHANGE IN CASH AND EQUIVALENTS.....	
CASH AND EQUIVALENTS, BEGINNING BALANCE.....	
CASH AND EQUIVALENTS, ENDING BALANCE.....	\$

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

Morgan's Foods, Inc.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
QUARTERS ENDED AUGUST 12, 2001 AND AUGUST 13, 2000
(unaudited)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The interim consolidated financial statements of Morgan's Foods, Inc. have been prepared without audit. In the opinion of Company Management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company's annual report on Form 10-K for the year ended February 25, 2001. Certain prior year amounts have been reclassified to conform to the current year presentation.

NOTE 2. INCOME (LOSS) PER COMMON SHARE

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

NOTE 3. ISSUANCE OF STOCK OPTIONS

Stock Options for 11,500 common shares were issued to executives on April 27, 2001 under the Key Employees Stock Option Plan at an exercise price of \$.85 per share, the market price on the date of grant. The plan provides that the options are exercisable after a waiting period of 6 months and that each option expires 10 years after its date of issue.

NOTE 4. NEW ACCOUNTING STANDARD

In July 2001, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 142, "Goodwill and Other Intangible Assets" (SFAS 142). SFAS 142 addresses the accounting for goodwill and other intangible assets after an acquisition. The most significant changes made by SFAS 142 are: 1) goodwill and intangible assets with indefinite lives will no longer be amortized; 2) goodwill and intangible assets with indefinite lives must be tested for impairment at least annually; and 3) the amortization period for the intangible assets with indefinite lives will no longer be limited to forty years. The Company plans to adopt SFAS 142 for its fiscal year beginning March 4, 2002, as required. The Company is currently evaluating the provision of SFAS 142 and has not yet determined the effect that adoption of this standard will have on its consolidated financial position or results of operations.

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

DESCRIPTION OF BUSINESS. Morgan's Foods, Inc. ("the Company") operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation and Taco Bell restaurants under franchises from Taco Bell Corporation. As of September 21, 2001, the Company operates 76 KFC restaurants, 8 Taco Bell restaurants, and 17 KFC/Taco Bell "2n1's" under franchises from KFC Corporation and franchises or licenses from Taco Bell Corporation and 2 Taco Bell/Pizza Hut Express "2n1's" operated under franchisees from Taco Bell Corporation and licenses from Pizza Hut Corporation. The Company's fiscal year is a 52 - 53 week year ending on the Sunday nearest the last day of February.

SUMMARY OF EXPENSES AS A PERCENTAGE OF REVENUES

	QUARTER ENDED	
	AUGUST 12, 2001	AUGUST 13, 2000
Cost of sales:		
Food, paper and beverage.....	30.4%	32.1%
Labor and benefits.....	25.8%	25.7%
Restaurant operating expenses.....	25.7%	23.4%
Depreciation and amortization.....	4.5%	4.5%
General and administrative expenses.....	5.6%	6.8%
Operating income.....	8.0%	6.5%

REVENUES. Revenues for the quarter ended August 12, 2001 were \$19,939,000 compared to \$19,282,000 for the quarter ended August 13, 2000. This increase of \$657,000 was due to \$85,000 in revenues generated by newly renovated restaurants and a 5.2% increase in comparable restaurant revenues. The increase in comparable restaurant revenues was primarily the result of effective product promotions by the franchisor during the quarter. These increases were partially offset by lost revenues of \$320,000 due to restaurants that were permanently closed during the prior fiscal year. Revenues for the twenty-four weeks ended August 12, 2001 were \$38,546,000 compared to \$36,848,000 for the twenty-four weeks ended August 13, 2000. The increase of \$1,698,000 was attributable to \$418,000 of revenues generated by newly built restaurants and restaurants to which a concept was added and a 5.7% increase in comparable restaurant revenues. These increases were partially offset by lost revenues of \$661,000 due to restaurants that were permanently closed during the prior fiscal year.

COSTS OF SALES - FOOD, PAPER AND BEVERAGES. Food, paper and beverage costs for the second quarter decreased as a percentage of revenue from 32.1% in fiscal 2001 to 30.4% in fiscal 2002. This decrease was primarily the result of the product promotions in the second quarter of fiscal 2002 having lower food cost than those which were promoted during the second quarter of fiscal 2001 and by the efficiencies gained from higher average restaurant volumes. Food, paper and beverage costs for the twenty-four weeks ended August 12, 2001 decreased to 30.7% of revenue compared to 31.5% in the year earlier period for the reasons discussed above.

COST OF SALES - LABOR AND BENEFITS. Labor and benefits were substantially unchanged as a percentage of revenue for the quarter ended August 12, 2001 at 25.8% compared to 25.7% for the year earlier quarter. Labor and

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benefits decreased as a percentage of revenue for the twenty-four weeks ended August 12, 2001 to 26.1% from 26.7% in the year earlier period. The decrease was primarily due to higher average restaurant volumes, decreased benefit costs and improved operating efficiencies.

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RESTAURANT OPERATING EXPENSES. Restaurant operating expenses increased as a percentage of revenue from 23.4% in the second quarter of fiscal 2001 to 25.7% in the second quarter of fiscal 2002. This was primarily caused by higher utility costs and an increase in KFC national advertising expenses from 2.0% of KFC revenue to 2.5% of KFC revenue. The increase in advertising was approved by the national advertising co-op and will remain in effect for the foreseeable future. Restaurant operating expenses for the twenty-four weeks ended August 12, 2001 increased to 25.5% of revenue of revenue compared to 24.3% of revenue in the comparable prior year period primarily due to the reasons discussed above.

DEPRECIATION AND AMORTIZATION. Depreciation and amortization for the fiscal 2002 second quarter increased to \$887,000 compared to \$865,000 in the prior year first quarter. The increase is primarily due to the addition of the newly built restaurants discussed above. Depreciation and amortization for the twenty-four weeks ended August 12, 2001 increased to \$1,774,000 from \$1,721,000 for the year earlier period for the reasons discussed above.

GENERAL AND ADMINISTRATIVE EXPENSES. General and administrative expenses decreased to \$1,113,000 in the second quarter of fiscal 2002 from \$1,316,000 in the second quarter of fiscal 2001. The decrease of \$203,000 was mainly the result of improved cost control at both the Corporate and field operations levels. General and administrative expenses for the twenty-four weeks ended August 12, 2001 decreased to \$2,307,000 compared to \$2,574,000 for the year earlier period due to the reasons discussed above.

LOSS ON RESTAURANT ASSETS. The losses on restaurant assets of \$25,000 and \$197,000 in the second quarters of fiscal 2002 and 2001 respectively, were the result of assets disposed of during the image enhancement of several restaurants as well as the disposal of obsolete equipment.

OPERATING INCOME. Operating income in the second quarter of fiscal 2002 increased to \$1,591,000 or 8.0% of revenues compared to \$1,247,000 or 6.5% of revenues for the second quarter of fiscal 2001. This increase was primarily the result of higher average restaurant volumes, the closing of several unprofitable restaurants since the second quarter of fiscal 2001 and improved operating efficiencies. Operating income for the twenty-four weeks ended August 12, 2001 increased to \$2,693,000 or 7.0% of revenue from \$1,954,000 or 5.3% for the reasons discussed above.

INTEREST EXPENSE. Interest expense on bank debt increased to \$1,158,000 in the second quarter of fiscal 2002 from \$1,137,000 in fiscal 2001 due to higher debt balances during the fiscal 2002 quarter necessary to fund the construction of restaurants during the past year. Interest expense on capitalized leases was substantially unchanged from the prior year second quarter. Interest expense on bank debt for the twenty-four weeks ended August 12, 2001 increased to \$2,369,000 from \$2,312,000 for the same reasons discussed above. Interest expense on capitalized leases was substantially unchanged from the prior year second quarter and for the twenty-four weeks.

OTHER INCOME. Other income for the quarter ended August 12, 2001

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increased to \$27,000 in the second quarter of fiscal 2002 from \$18,000 in the second quarter of fiscal 2001 due to increased interest income earned on increased average cash balances. Other income for the twenty-four weeks ended August 12, 2001 increased to \$80,000 from \$66,000 due to the reasons discussed above.

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PROVISION FOR INCOME TAXES. The provision for income taxes was \$8,000 for the quarter ended August 12, 2001 compared to \$4,000 in the prior year quarter due to the improved operating results discussed above. The provision for income taxes for the twenty-four weeks ended August 12, 2001 decreased to \$1,000 as compared to \$7,000 for the year earlier period due to an adjustment, during the first quarter of fiscal 2002, to previous estimates for taxes that are paid in certain jurisdictions.

LIQUIDITY AND CAPITAL RESOURCES. Cash flow activity for the twenty-four weeks of fiscal 2002 and fiscal 2001 is presented in the Consolidated Statements of Cash Flows. Cash provided by operating activities was \$2,206,000 for the twenty-four weeks ended August 12, 2001. The Company paid scheduled long-term bank and capitalized lease debt of \$1,060,000 in fiscal 2002.

The KFC operations of the Company have historically provided sufficient cash flow to service the Company's debt, refurbish and upgrade restaurant properties and cover administrative overhead. Management believes that operating cash flow will provide sufficient capital to continue to operate and maintain its restaurants, service the Company's debt and support required corporate expenses.

Certain of the Company's debt arrangements require the maintenance of a consolidated fixed charge coverage ratio of 1.2 to 1.0 regarding all of its mortgage loans and individual restaurant coverage ratios of 1.4 to 1.0 on certain of its loans as measured at each of the Company's fiscal year ends. At February 25, 2001, the Company was in compliance with the consolidated ratio of 1.2 applicable to \$43,621,000 of its loans and fell short of compliance on the consolidated ratio regarding \$6,501,000 of its loans with another lender. Additionally, the Company was not in compliance with the 1.4 unit level ratio on certain of its restaurants. The Company obtained waivers of these violations from the applicable lenders and expects to be in compliance with the minimum coverage ratios and other terms and conditions of the agreements by the end of fiscal 2002.

The Company is currently not in full compliance with the American Stock Exchange financial condition guidelines for continued listing. Specifically, the guidelines indicate that any company with shareholders' equity less than \$4,000,000 and losses in 3 of its last 4 fiscal years may be considered for delisting. This condition has been reviewed with representatives of the American Stock Exchange who indicated that the Company's performance will continue to be monitored by the Exchange.

The Board of Directors of the Company at its meeting on June 22, 2001 authorized the purchase of up to 250,000 shares of the Company's common stock in the open market from time to time over the next twelve months. On July 11, 2001 the Company purchased 73,730 shares which constitutes all of the stock formerly held by the Morgan's Foods, Inc. 401(k) Profit Sharing Plan under authority granted by the Board of Directors specifically for that purpose. On August 13, 2001 the Company purchased 100,334 shares under its previously disclosed

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authorization to purchase 250,000 shares during the twelve months ending June 21, 2002.

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 consist of portions of Ohio, Pennsylvania, Missouri, Illinois, West Virginia and New York.

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SIGNATURES

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

Morgan's Foods, Inc.

(Registrant)

Dated: September 26, 2001

By: /s/ Kenneth L. Hignett

Kenneth L. Hignett
Senior Vice President,
Chief Financial Officer & Secretary

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