MORGANS FOODS INC
Form 10-K
June 03, 2013

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 3, 2013 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

Securities registered pursuant to Section 12(g) of the Act: Common Shares, Without Par Value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes __ No X

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 __ No X

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 X No __

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes X__ No __

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. [X]

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 definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer...... Accelerated filer ..... Non-accelerated filer …Smaller Reporting Company…X….

Indicate by check mark whether the registration is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes __ No X

As of August 12, 2012, the aggregate market value of the common stock held by nonaffiliates of the Registrant was $3,357,264.

As of May 6, 2013, the Registrant had 4,039,147 common shares outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III incorporates by reference certain information from the Definitive Proxy Statement for the 2013 annual meeting of shareholders to be held on July 2, 2013 and to be filed with the Securities and Exchange Commission about June 3, 2013.

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, and Pizza Hut Express restaurants under licenses from Pizza Hut Corporation. As of May 24, 2013, the Company operates 57 KFC restaurants, four Taco Bell restaurants, nine KFC/Taco Bell "2n1's" under franchises from KFC Corporation and franchises from Taco Bell Corporation and three Taco Bell/Pizza Hut Express "2n1's" under franchises 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.

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 franchise 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.

Of the 73 KFC, Taco Bell and "2n1" restaurants operated by the Company as of May 24, 2013, 13 are located in Ohio, 44 in Pennsylvania, seven in Missouri, one in Illinois, seven in West Virginia and one 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 franchises 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 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 and Pizza Hut Corporation are satisfactory. For further discussion of the requirements of the franchise and license agreements see “Other Contractual Obligations and Commitments” in Part II of this report.

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 and Pizza Hut Express unit is to be inspected by KFC Corporation, Taco Bell Corporation and Pizza Hut Corporation, 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 and pizza 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, 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 primarily through McLane Foodservice, Inc.

Growth

The Company built no new restaurants in fiscal years 2013 or 2012 and closed two restaurants in fiscal 2013 and 12 restaurants in fiscal 2012.

Employees

As of May 20, 2013, the Company employed approximately 1,495 persons, including 39 administrative and 181 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.

Image Enhancement and Capital Expenditure Requirements

The Company faces significant image enhancement and relocation requirements in future fiscal years as described under "Required Image Enhancements" in Part II of this report. There is no assurance that the Company will be able to fund these obligations when due. Lack of funding would have a material adverse effect on the operations of the Company, including the loss of restaurants subject to enhancement or relocation requirements under applicable franchise agreements and default under its financing arrangements.

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.

Failure to Meet Loan Covenants

If the Company does not meet the periodic requirements of its loan covenants and is unable to obtain waivers of these deficiencies, its lenders could take actions which would have a material adverse effect on the Company's results of operations. The Company does not have a working capital line to use in managing its cash flow needs.

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 owns or controls through leases 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.

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.

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. The Company is 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, 2017 and the rent during the current term is $5,000 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 73 KFC, Taco Bell and "2n1" restaurants, the Company owns the land and building for six locations, owns the building and leases the land for 20 locations and leases the land and building for 47 locations. None of the owned properties are subject to mortgages. Additionally, the Company owns the land and building for three closed locations, and is obligated for various terms under leases on two other closed locations. Remaining lease terms (including renewal options) range from 2 months to 37 years and average approximately 20 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 $24,000 to $136,000. In addition, four of these leases require payment of additional rentals based on a percentage of gross sales in excess of certain base amounts. Sales for four KFC, Taco Bell and "2n1" restaurants exceeded the respective base amounts in fiscal 2013. Thirteen of the leased locations are covered by two master leases which aggregate the lease payment amounts for all of the properties included in the master leases and do not specify a rent amount for each individual location. The Company allocates the rent under the master leases to each specific location for internal bookkeeping purposes.

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

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable.

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:			
James J. Liguori	64	President and Interim Chief Executive Officer	June 1979
Kenneth L. Hignett	66	Senior Vice President Chief Financial Officer & Secretary	May 1989
Other Officers:			
Vincent J. Oddi	70	Vice President Restaurant Development	September 1979
Ramesh J. Gursahaney	64	Vice President – Operations Support Services	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 (OTC Bulletin Board) 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 3, 2013:		
1st Quarter	$1.40	$0.81
2nd Quarter	3.72	0.85
3rd Quarter	2.45	2.01
4th Quarter	2.50	1.15
Year ended February 26, 2012:		
1st Quarter	$2.05	$0.50
2nd Quarter	0.85	0.02
3rd Quarter	1.02	0.35
4th Quarter	1.15	0.35

As of May 8, 2013, the Company had approximately 694 shareholders of record. The Company has paid no dividends since 1975 and does not expect to pay dividends in the foreseeable future.

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

Equity Compensation Plan Information as of March 3, 2013

Plan Category	Number of securities to be issued upon exercise of	Weighted average exercise price of outstanding	Number of shares remaining for future issuance

	outstanding options	options	under equity compensation plans
Equity Compensation plans approved by security holders	145,650	$ 1.50	-
Equity Compensation plans not approved by security holders	350	$ 1.50	-
Total	146,000	$ 1.50	-

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, 2008, 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 12 restaurant companies each of which has a market capitalization comparable to that of the Company.

	2008	**2009**	**2010**	**2011**	**2012**	**2013**
Morgan's Foods, Inc.	**100**	30.53	52.67	31.45	13.74	26.72
S&P MidCap 400 Index	**100**	58.00	96.87	128.28	132.96	150.47
Peer Group	**100**	30.51	59.20	90.54	87.27	105.23

The companies in the peer group are Boston Restaurant Assoc. Inc., Brazil Fast Food Corp., Briazz Inc.(included through 2009), Einstein Noah Restaurant Grp, Flanigans Enterprises Inc., Good Times Restaurants Inc., Granite City Food & Brewery, Grill Concepts 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 3, 2013, 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				
	March 3,	**February 26,**	**February 27,**	**February 28,**	**March 1,**
	2013	2012	2011	2010	2009
$ in thousands, except per share amounts					
Revenues	$86,866	$82,237	$89,891	$90,544	$92,485
Cost of sales:					
Food, paper and beverage	28,335	27,238	28,267	28,457	29,695
Labor and benefits	25,010	23,794	26,533	26,448	26,850
Restaurant operating expenses	21,935	21,298	23,748	23,931	24,068
Depreciation and amortization	2,836	2,598	2,831	3,026	3,224
General and administrative expenses	4,941	5,311	5,450	5,409	5,740
Loss on restaurant assets	719	766	841	75	417
Early Extinguishment of Debt	-	405	138	85	222
Operating income	3,090	827	2,083	3,113	2,269
Interest expense	(2,975)	(2,265)	(2,390)	(2,568)	(3,604)
Other income and expense, net	122	148	(44)	191	336
Provision for income taxes	(375)	(390)	(637)	(340)	(391)
Net income (loss)	(138)	(1,680)	(988)	396	(1,390)
Basic net income (loss) per comm. sh. (1)	(0.05)	(0.57)	(0.34)	0.13	(0.47)
Diluted net income (loss) per comm. sh. (1)	(0.05)	(0.57)	(0.34)	0.13	(0.47)
Working capital deficiency	(2,230)	(432)	(29,770)	(3,984)	(16,091)
Total assets	50,500	52,426	44,088	48,925	51,988
LT debt and capital lease - current portion	1,182	276	27,097	3,209	16,514
Long-term debt less current maturities	7,338	8,220	-	29,725	19,738
Long-term capital lease obligations	22,079	22,505	1,013	1,061	1,105
Shareholders' equity (deficit)	(1,183)	(1,045)	635	1,623	1,171
Net cash flow operating activities	1,615	1,555	3,667	3,849	(98)
Net cash flow investing activities	(1,614)	17,977	1,047	(1,539)	1,727
Net cash flow financing activities	(485)	(19,111)	(5,885)	(3,362)	(2,800)

Certain amounts in prior periods have been reclassified to conform to the current period presentation

(1) Computed based upon the basic weighted average number of common shares outstanding during each year, which were 2,934,995 in 2013, 2012, 2011, 2010 and 2009 and the diluted weighted average number of common and common equivalent shares outstanding during each year, which were 2,934,995 in 2013, 2,934,995 in 2012 and 2011, 2,991,941 in 2010 and 2,934,995 in 2009.

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

Results of Operations

During fiscal 2013 and 2012 the Company operated KFC franchised restaurants, Taco Bell franchised restaurants and various “2n1” restaurants which include the KFC, Taco Bell and Pizza Hut 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 75 in 2013 and 77 in 2012.

Summary of Expenses and Operating Income as a Percentage of Revenues

	2013	**2012**
Cost of sales:		