

MEXICAN RESTAURANTS INC
Form 10-Q
November 12, 2009

UNITED STATES
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 quarterly period ended September 27, 2009

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.

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Yes

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 (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes

No

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 definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

Yes

No

Number of shares outstanding of each of the issuer's classes of common stock, as of November 10, 2009: 3,288,141 shares, par value \$.01.

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PART 1 - FINANCIAL INFORMATION

Item 1. Financial Statements

Mexican Restaurants, Inc. and Subsidiaries
Consolidated Balance Sheets

| ASSETS | (Unaudited) 9/27/2009 | 12/28/2008 (1) (As adjusted) |
|---|--------------------------|---------------------------------|
| Current assets: | | |
| Cash | \$ 189,684 | \$ 879,206 |
| Royalties receivable | 90,583 | 144,196 |
| Other receivables | 821,362 | 1,117,815 |
| Inventory | 569,798 | 597,237 |
| Income taxes receivable | 255,308 | 194,856 |
| Prepaid expenses and other current assets | 1,133,408 | 902,340 |
| Assets related to discontinued operations | 145,098 | 196,465 |
| Assets held for sale | -- | 1,111,513 |
| Total current assets | 3,205,241 | 5,143,628 |
| Property and equipment, net | 17,726,315 | 17,866,902 |
| Goodwill | 5,017,243 | 6,273,705 |
| Deferred tax assets | 1,948,763 | 1,976,427 |
| Other assets | 175,020 | 208,325 |
| Other assets related to discontinued operations | 33,878 | 34,178 |
| Total Assets | \$ 28,106,460 | \$ 31,503,165 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 1,994,563 | \$ 2,288,698 |
| Accrued sales, liquor, and payroll taxes | 862,701 | 1,054,078 |
| Accrued expenses | 989,569 | 1,191,740 |
| Liabilities related to assets held for sale | -- | 195,740 |
| Current portion of liabilities associated with leasing and exit activities | 352,623 | 325,625 |
| Total current liabilities | 4,199,456 | 5,055,881 |
| Long-term debt | 5,150,000 | 7,500,000 |
| Liabilities associated with leasing and exit activities, net of current portion | 636,631 | 567,445 |
| Deferred gain | 780,535 | 936,642 |
| Other liabilities | 1,962,476 | 1,956,921 |
| Total Liabilities | 12,729,098 | 16,016,889 |

| | | |
|---|---------------|---------------|
| Stockholders' equity: | | |
| Preferred stock, \$0.01 par value, 1,000,000 shares authorized, none issued | -- | -- |
| Common stock, \$0.01 par value, 20,000,000 shares authorized, 4,732,705 shares issued | 47,327 | 47,327 |
| Additional paid-in capital | 19,270,442 | 19,442,049 |
| Retained earnings | 8,860,188 | 9,120,885 |
| Treasury stock at cost of 1,444,564 and 1,481,064 common shares at 9/27/09 and 12/28/08, respectively | (12,800,595) | (13,123,985) |
| Total stockholders' equity | 15,377,362 | 15,486,276 |
| Total Liabilities and Stockholders' Equity | \$ 28,106,460 | \$ 31,503,165 |

(1) December 28, 2008 balances have been reclassified for discontinued operations. See Note 7.

See accompanying notes to consolidated financial statements.

Mexican Restaurants, Inc. and Subsidiaries
Consolidated Statements of Operations
(Unaudited)

| | 13-Week Period Ended 9/27/2009 | 13-Week Period Ended 9/28/2008 | 39-Week Period Ended 9/27/2009 | 39-Week Period Ended 9/28/2008 |
|---|---|---|---|---|
| Revenues: | | | | |
| Restaurant sales | \$ 17,096,233 | \$ 17,451,128 | \$ 54,217,484 | \$ 54,565,676 |
| Franchise fees, royalties and other | 128,962 | 135,496 | 393,829 | 406,252 |
| Business interruption | 107,318 | 127,525 | 210,846 | 248,717 |
| | 17,332,513 | 17,714,149 | 54,822,159 | 55,220,645 |
| Costs and expenses: | | | | |
| Cost of sales | 4,961,965 | 5,073,611 | 15,475,502 | 15,711,467 |
| Labor | 5,835,840 | 5,765,679 | 18,008,937 | 17,746,704 |
| Restaurant operating expenses | 4,419,617 | 4,698,151 | 13,724,614 | 13,748,135 |
| General and administrative | 1,530,024 | 1,754,122 | 4,848,791 | 5,450,463 |
| Depreciation and amortization | 891,681 | 805,218 | 2,644,651 | 2,414,883 |
| Pre-opening costs | 21,745 | 43,810 | 21,745 | 91,121 |
| Impairment and restaurant closure costs | 116,937 | 67,597 | 354,168 | 122,426 |
| Loss (gain) on involuntary disposals | 18,330 | 140,938 | 26,127 | (134,771) |
| Loss on sale of other property and equipment | 46,430 | 131,509 | 120,126 | 173,179 |
| | 17,842,569 | 18,480,635 | 55,224,661 | 55,323,607 |
| Operating loss | (510,056) | (766,486) | (402,502) | (102,962) |
| Other income (expense): | | | | |
| Interest income | 815 | 1,242 | 2,678 | 4,152 |
| Interest expense | (39,870) | (92,003) | (144,981) | (325,215) |
| Other, net | 6,742 | 10,500 | 26,844 | 27,958 |
| | (32,313) | (80,261) | (115,459) | (293,105) |
| Loss from continuing operations before income taxes | (542,369) | (846,747) | (517,961) | (396,067) |
| Income tax benefit | 309,755 | 362,961 | 306,772 | 260,198 |
| Loss from continuing operations | (232,614) | (483,786) | (211,189) | (135,869) |
| Discontinued Operations: | | | | |
| Income from discontinued operations | - | 76,807 | 36,021 | 138,846 |
| Restaurant closure income (expense) | - | (6,062) | (190,941) | 46,227 |
| Gain (loss) on sale of assets | - | - | 386,502 | (2,075) |
| Income from discontinued operations before income taxes | - | 70,745 | 231,582 | 182,998 |
| Income tax expense | - | (91,518) | (281,090) | (117,112) |
| Income (loss) from discontinued operations | - | (20,773) | (49,508) | 65,886 |

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| | | | | |
|--|---------------|---------------|---------------|--------------|
| Net loss | \$ (232,614) | \$ (504,559) | \$ (260,697) | \$ (69,983) |
| Basic income (loss) per common share | | | | |
| Loss from continuing operations | \$ (0.07) | \$ (0.14) | \$ (0.06) | \$ (0.04) |
| Income (loss) from discontinued operations | - | (0.01) | (0.02) | 0.02 |
| Net loss | \$ (0.07) | \$ (0.15) | \$ (0.08) | \$ (0.02) |
| Diluted income (loss) per common share | | | | |
| Loss from continuing operations | \$ (0.07) | \$ (0.14) | \$ (0.06) | \$ (0.04) |
| Income (loss) from discontinued operations | - | (0.01) | (0.02) | 0.02 |
| Net loss | \$ (0.07) | \$ (0.15) | \$ (0.08) | \$ (0.02) |
| Weighted average number of common shares (basic) | 3,286,201 | 3,259,087 | 3,276,306 | 3,252,858 |
| Weighted average number of common shares (diluted) | 3,286,201 | 3,259,087 | 3,276,306 | 3,252,858 |

See accompanying notes to consolidated financial statements.

Mexican Restaurants, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

| | 39-Week Period Ended 9/27/2009 | 39-Week Period Ended 9/28/2008 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net loss | \$(260,697) | \$(69,983) |
| (Income) loss from discontinued operations | 49,508 | (65,886) |
| Loss from continuing operations | (211,189) | (135,869) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,644,651 | 2,414,883 |
| Deferred gain amortization | (156,107) | (156,107) |
| Impairment and restaurant closure costs | 354,168 | 122,426 |
| (Gain) loss on involuntary disposals | 26,127 | (134,771) |
| Loss on sale of other property & equipment | 120,126 | 173,179 |
| Stock based compensation expense | 232,827 | 141,785 |
| Excess tax expense (benefit) – stock based compensation expense, net | 39,751 | (485) |
| Deferred income tax benefit | (13,629) | (190,753) |
| Changes in operating assets and liabilities: | | |
| Royalties receivable | 53,613 | (71,082) |
| Other receivables | 296,453 | (63,884) |
| Inventory | 27,440 | (123,389) |
| Income taxes receivable | (100,203) | (43,144) |
| Prepaid and other current assets | (231,068) | (182,346) |
| Other assets | 1,392 | 42,421 |
| Accounts payable | (374,993) | (32,472) |
| Accrued expenses and other liabilities | (577,674) | (611,787) |
| Liabilities associated with leasing and exit activities | 180,088 | (102,357) |
| Deferred rent and other long-term liabilities | (65,488) | (9,856) |
| Total adjustments | 2,457,474 | 1,172,261 |
| Net cash provided by continuing operations | 2,246,285 | 1,036,392 |
| Net cash provided by (used in) discontinued operations | (455,820) | 147,437 |
| Net cash provided by operating activities | 1,790,465 | 1,183,829 |
| Cash flows from investing activities: | | |
| Insurance proceeds received from involuntary disposals | 54,731 | 385,770 |
| Purchase of property and equipment | (2,762,320) | (2,953,593) |
| Proceeds from landlord for lease buildout | 75,000 | 99,144 |
| Proceeds from sale of property and equipment | - | 24,071 |
| Net cash used in continuing operations | (2,632,589) | (2,444,608) |
| Purchase of property and equipment | (15,250) | (478,566) |
| Cash received from sale of La Seniorita | 2,557,603 | - |
| Net cash provided by (used in) discontinued operations | 2,542,353 | (478,566) |
| Net cash used in investing activities | (90,236) | (2,923,174) |
| Cash flows from financing activities: | | |
| Borrowings under line of credit agreement | 900,000 | 2,260,000 |

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| | | |
|--|-------------|-------------|
| Payments under line of credit agreement | (3,250,000) | (1,160,000) |
| Excess tax benefit – stock based compensation expense, net | (39,751) | 485 |
| Exercise of stock options | - | 15,755 |
| Net cash provided by (used in) financing activities | (2,389,751) | 1,116,240 |
| Net decrease in cash | (689,522) | (623,105) |
| Cash at beginning of period | 879,206 | 1,154,629 |
| Cash at end of period | \$ 189,684 | \$ 531,524 |

Supplemental disclosure of cash flow information:

Cash paid during the period:

| | | |
|--------------|------------|------------|
| Interest | \$ 138,762 | \$ 354,413 |
| Income taxes | \$ 88,150 | \$ 92,771 |

See accompanying notes to consolidated financial statements.

MEXICAN RESTAURANTS, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Basis of Presentation

In the opinion of Mexican Restaurants, Inc. (the “Company”), the accompanying unaudited consolidated financial statements contain all adjustments (consisting only of normal recurring accruals and adjustments) necessary for a fair presentation of the consolidated financial position as of September 27, 2009, and the consolidated statements of operations and cash flows for the 13-week and 39-week periods ended September 27, 2009 and September 28, 2008. The consolidated statements of operations for the 13-week and 39-week periods ended September 27, 2009 and September 28, 2008 are not necessarily indicative of the results to be expected for the full year or any other interim period. During the interim periods, we follow the accounting policies described in the notes to our consolidated financial statements in the Annual Report and Form 10-K for the year ended December 28, 2008 filed with the Securities and Exchange Commission on March 26, 2009. Reference should be made to such consolidated financial statements for information on such accounting policies and further financial detail.

The Company classifies as discontinued operations for all periods presented any component of the Company’s business that the Company believes is probable of being sold within the next 12 months and that has operations and cash flows that are clearly distinguishable operationally and for financial reporting purposes. For those components, the Company has no significant continuing involvement after disposal, and their operations and cash flows are eliminated from ongoing operations. Sales of significant components of the Company’s business not classified as discontinued operations are reported as a component of income from continuing operations.

Impact of Recently Issued Accounting Standards

On September 27, 2009, the Company adopted changes issued by the Financial Accounting Standards Board (“FASB”) to the authoritative hierarchy of U.S. Generally Accepted Accounting Principles (“GAAP”). These changes establish the FASB Accounting Standards Codification (“ASC”) as the source of authoritative accounting principles recognized by the FASB to be applied by nongovernmental entities in the preparation of financial statements in conformity with GAAP. Rules and interpretive releases of the Securities and Exchange Commission (“SEC”) under authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. The FASB will no longer issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts; instead the FASB will issue Accounting Standards Updates (“ASU”). The ASU will not be authoritative in their own right as they will only serve to update the Codification. These changes and the Codification itself do not change GAAP. Other than the manner in which new accounting guidance is referenced, the adoption of these changes had no impact on our consolidated balance sheets, results of operations or cash flows.

In April 2008, the FASB amended FASB ASC Subtopic 350-30 “General Intangibles Other Than Goodwill.” FASB ASC Subtopic 350-30 defines the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset to improve consistency between the useful life of a recognized intangible asset and the period of expected cash flows used to measure the fair value of the asset. The requirement for determining the useful lives must be applied prospectively to intangible assets acquired after the effective date and the disclosure requirements must be applied prospectively to all intangible assets recognized as of, and subsequent to, the effective date. FASB ASC Subtopic 350-30 is effective for financial statements issued for fiscal years beginning after December 15, 2008. Such adoption has not had a material effect on our consolidated balance sheets, results of operations or cash flows.

In June 2008, the FASB amended FASB ASC 260, "Earnings Per Share". As required by FASB ASC 260, unvested share-based payment awards that contain rights to receive nonforfeitable dividends (whether paid or unpaid) are participating securities, and should be included in the two-class method of computing EPS. The amendment is effective for fiscal years beginning after December 15, 2008, and interim periods within those years. Such adoption has not had a material effect on our consolidated balance sheets, results of operations or cash flows.

In May 2009, the FASB issued FASB ASC 855, "Subsequent Events", which establishes guidance for the accounting for and the disclosure of events that happen after the date of the balance sheet but before the release of the consolidated financial statements, otherwise known as "subsequent events". FASB ASC 855 requires us to disclose the date through which we have evaluated subsequent events and whether the date corresponds with the release of our financial statements. The guidance is effective for interim reporting periods ending after June 15, 2009. The adoption of FASB ASC 855 resulted in additional quarterly and annual disclosures only.

In August 2009, the FASB issued ASU No. 2009-05, an update to FASB ASC 820, "Fair Value Measurements and Disclosures." This update provides amendments to reduce potential ambiguity in financial reporting when measuring the fair value of liabilities. Among other provisions, this update provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more of the valuation techniques described in ASU 2009-05. ASU 2009-05 will become effective for the Company's annual financial statements for the year ended January 3, 2010. We do not expect that the adoption of ASU 2009-05 will have a material impact on our consolidated balance sheets, results of operations or cash flows.

2. Income Taxes

In 2006, the State of Texas enacted a business tax that is imposed on gross margin to replace the State's then-current franchise tax regime. The legislation's effective date was January 1, 2007, and as a result our first Texas margins tax ("TMT") return in 2008 was based on our 2007 operations. Although the TMT is imposed on an entity's gross margin rather than on its net income, certain aspects of the tax make it similar to an income tax. We have properly determined the impact of the legislation in the determination of our reported state current and deferred income tax liability.

In determining the provision for income taxes, the Company uses an estimated annual effective tax rate based on forecasted annual income and permanent items, statutory tax rates and tax planning opportunities in the various jurisdictions in which the Company operates. The impact of significant discrete items is separately recognized in the quarter in which they occur.

3. Stock-Based Compensation

At September 27, 2009, we had one equity-based compensation plan from which stock-based compensation awards can be granted to eligible employees, officers or directors, known as the 2005 Long Term Incentive Plan. On May 28, 2008, the shareholders approved an amendment to the 2005 Long Term Incentive Plan to increase from 350,000 to 425,000 shares the number of shares authorized for issuance under this plan. The Company's 1996 Long Term Incentive Plan, Stock Option Plan for Non-Employee Directors and 1996 Manager's Stock Option Plan have each terminated in accordance with its terms, but there are still options which remain exercisable under these plans until the earlier of ten years from the date of grant or no more than 90 days after the optionee ceases to be an employee of the Company. These Company plans are described in more detail in Note 5 of the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended December 28, 2008.

On May 28, 2008, our Board of Directors approved restricted stock grants to one Board member for 3,000 shares, vesting in equal increments over three years, and one consultant for 2,000 shares, vesting in equal increments over two years.

On May 28, 2008, our shareholders approved the grant of 60,000 long-term performance units under the 2005 Long Term Incentive Plan to Mr. Glowacki.

In accordance with the May 22, 2007 Board approved grant, 10,000 shares of restricted stock were granted to Mr. Glowacki on May 22, 2009. The shares will vest over a four year period at a rate of 25% per year.

We receive a tax deduction for certain stock option exercises during the period in which the options are exercised. These deductions are generally for the excess of the price for which the options were sold over the exercise prices of the options. No stock options were exercised during the 13-week period ended September 27, 2009 and we received \$5,865 for the exercise of options for 1,750 shares during the 13-week period ended September 28, 2008. No stock options were exercised during the 39-week period ended September 27, 2009 and we received \$15,755 for the exercise of options for 4,625 shares during the 39-week period ended September 28, 2008.

4. Income (Loss) per Share

Basic income per share is based on the weighted average shares outstanding without any dilutive effects considered. Diluted income per share is calculated using the treasury stock method, which considers unrecognized compensation expense as well as the potential excess tax benefits that reflect the current market price and total compensation expense to be recognized. If the sum of the assumed proceeds, including the unrecognized compensation costs calculated under the treasury stock method, exceeds the average stock price, those options would be considered antidilutive and therefore excluded from the calculation of diluted income per share. For the 13-week and 39-week periods ended September 27, 2009, weighted-average shares outstanding, assuming dilution, excludes the impact of 2,975 and 1,938 common stock equivalents, respectively, due to our net loss position in those periods. For the 13-week and 39-week periods ended September 28, 2008, weighted-average shares outstanding, assuming dilution, excludes the impact of 60,783 and 59,178 common stock equivalents, respectively, due to our net loss position in those periods.

5. Long-term Debt

We entered into a Credit Agreement with Wells Fargo Bank, N.A. (“Wells Fargo”) in June 2007 (the “Wells Fargo Agreement”). Originally, the Wells Fargo Agreement provided for a revolving loan of up to \$10 million, but the Wells Fargo Agreement was amended effective December 28, 2008, reducing the revolving loan by the amount of the net proceeds received from the sale of La Seniorita, which reduced the revolver availability to approximately \$7.3 million on April 7, 2009. Effective June 28, 2009, the Wells Fargo Agreement was further amended primarily to extend the maturity date from June 29, 2010 to June 29, 2012. The June 2009 amendment to the Wells Fargo Agreement also increased the stipulated percentages payable in connection with London Interbank Offered Rate (“LIBOR”) loans and letters of credit and changed total leverage ratio limits as a condition precedent to loans for growth capital expenditures. Under the Wells Fargo Agreement, we are required to maintain certain leverage ratios and fixed charge coverage ratios. We were in compliance with all covenants under the Wells Fargo Agreement at September 27, 2009.

At our option, the revolving loan bears an interest rate equal to the Wells Fargo Base Rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, we are impacted by changes in the Base Rate and LIBOR. We are subject to a non-use fee of 0.50% on the unused portion of the revolver from the date of the Wells Fargo Agreement. The Wells Fargo Agreement also allows up to \$2.0 million in annual stock repurchases. We have pledged the stock of our subsidiaries, our leasehold interests, our patents and trademarks and our furniture, fixtures and equipment as collateral for our credit facility with Wells Fargo.

6. Related Party Transactions

Our Vice Chairman of the Board of Directors owns a Casa Olé franchise restaurant for which the Company receives royalties. For the 13-week periods ended September 27, 2009 and September 28, 2008, the Company recognized royalty income of \$5,660 and \$5,426, respectively, related to this restaurant. For the 39-week periods ended September 27, 2009 and September 28, 2008, the Company recognized royalty income of \$17,908 and \$17,126, respectively, related to this restaurant.

7. Discontinued Operations

On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Seniorita restaurant chain (consisting of five site locations) located in Michigan. On January 24, 2009, we closed one underperforming Mission Burrito restaurant. The results of operations for the current and prior periods for the La Seniorita chain and the closed

Mission Burrito restaurant have been reported as discontinued operations.

Also, the assets and liabilities related to the sale of the La Senorita chain that were sold have been classified as held for sale in the consolidated balance sheet as of December 28, 2008. The assets and liabilities of the Mission Burrito restaurant and certain assets and liabilities of La Senorita that were not sold have been classified as related to discontinued operations. Current liabilities related to discontinued operations of the closed Mission Burrito restaurant include estimated lease obligations and are included with current portion of liabilities associated with leasing and exit activities.

8. Fair Value of Measurements

The carrying amount of receivables, accounts payables and accrued expenses approximates fair value because of the immediate or short-term maturity of these financial instruments. The fair value of long-term debt is determined using current applicable rates for similar instruments and approximates the carrying value of such debt.

9. Subsequent Events

In connection with preparation of the consolidated financial statements, we evaluated subsequent events after the consolidated balance sheet date of September 27, 2009 through November 12, 2009, the date the consolidated financial statements were issued.

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 that 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: national, regional or local economic and real estate conditions; inflation; increased food, labor and benefit costs; growth strategy; dependence on executive officers; geographic concentration; increasing susceptibility to adverse conditions in the region; changes in consumer tastes and eating and discretionary spending habits; the risk of food-borne illness; demographic trends; inclement weather; traffic patterns; the type, number and location of competing restaurants; 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 us in this report and in our most recently filed Annual Report and Form 10-K that attempt to advise readers of the risks and factors that may affect our business. We undertake no obligation to update any such statements or publicly announce any updates or revisions to any of the forward-looking statements contained herein, to reflect any change in our expectations with regard thereto or any change in events, conditions, circumstances or assumptions underlying such statements.

General

We operate and franchise Mexican-theme restaurants featuring various elements associated with the casual dining experience under the names Casa Olé, Monterey's Little Mexico, Tortuga Coastal Cantina, Crazy Jose's and Mission Burrito. On April 7, 2009, we sold our La Senorita chain in order to focus our resources on our other store brands. At September 27, 2009 we operated 55 restaurants, franchised 17 restaurants and licensed two restaurants in various communities in Texas, Louisiana and Oklahoma.

Our primary source of revenues is the sale of food and beverages at Company-owned restaurants. We also derive revenues from franchise fees, royalties and other franchise-related activities with respect to our franchised restaurants. Franchise fee revenue from an individual franchise sale is recognized when all services relating to the sale have been performed and the restaurant has commenced operations. Initial franchise fees relating to area franchise sales are recognized ratably in proportion to the services that are required to be performed pursuant to the area franchise or development agreements and proportionately as the restaurants within the area are opened.

Over the last five years, we have focused our growth and development efforts primarily upon assimilating two significant acquisitions (13 restaurants purchased in 2004 from a franchisee and two Mission Burrito restaurants, and related concept rights, acquired in 2006), developing new prototypes for our Casa Olé, Monterey's and Mission Burrito restaurant concepts and initiating a program whereby we remodel several of our existing restaurants each year.

On October 6, 2009, we implemented planned expense reductions to reduce general and administrative expenses to achieve a level of expense that management believes is sustainable through fiscal year 2010. In implementing the cost savings, severance pay of approximately \$190,000 was incurred related to staff reductions at the corporate office. Total cost savings of approximately \$1.1 million through fiscal year 2010 is expected from planned general and administrative expense reductions related to the decrease in corporate payroll costs as well as reduced marketing and other general and administrative costs.

Results of Operations

Revenues. Our revenues for the third quarter of fiscal year 2009 decreased \$381,636 or 2.2% to \$17.3 million compared with \$17.7 million for the same quarter in fiscal year 2008. Restaurant sales for third quarter 2009 decreased by \$354,895 or 2.0% to \$17.1 million compared with \$17.4 million for the third quarter of 2008. Franchised-owned restaurant sales, as reported by franchisees, decreased approximately 3.4% over the same quarter in fiscal 2008. The decrease in restaurant revenues primarily reflects a decrease in same-store sales, partially offset by new restaurant revenues and revenues of restaurants that were temporarily closed last year due to Hurricanes Gustav and Ike. For the third quarter ended September 27, 2009, Company-owned same-restaurant sales decreased approximately 11.4%, caused by a weakened economy.

On a year-to-date basis, the Company's revenue decreased \$398,486 to \$54.8 million compared to \$55.2 million for the same 39-week period in fiscal 2008. Restaurant sales for the 39-week period ended September 27, 2009 decreased \$348,192 to \$54.2 million compared to \$54.6 million for the same 39-week period in fiscal 2008. Franchised-owned restaurant sales, as reported by franchisees, decreased approximately 2.9% over the same 39-week period in fiscal 2008. The decrease in restaurant revenues primarily reflects a decrease in same-store sales, partially offset by new restaurant revenues and revenues of restaurants that were temporarily closed last year due to Hurricanes Gustav and Ike. For the 39-week period ended September 27, 2009, Company-owned same-restaurant sales decreased approximately 5.6%.

Costs and Expenses. Costs of sales, consisting of food, beverage, liquor, supplies and paper costs, was 29.0% as a percentage of restaurant sales for the third quarter of fiscal year 2009 compared with 29.1% for the third quarter of fiscal year 2008. As a percentage of restaurant sales, dairy, cheese and tortilla costs declined 106 basis points in the third quarter of fiscal year 2009, but were offset by higher costs in all other categories.

On a year-to-date basis, costs of sales decreased as a percent of restaurant sales 30 basis points to 28.5% compared with 28.8% for the same 39-week period of fiscal year 2008. The decrease primarily reflects cost improvements for dairy and cheese, which declined as a percentage of restaurant sales by 90 basis points, offset by increases in all other costs and expenses except for dry goods.

Labor and other related expenses increased as a percentage of restaurant sales 110 basis points to 34.1% as compared with 33.0% in the third quarter of fiscal year 2008. The increase reflects labor cost leverage that is lost when same-store sales decline; for example, both management labor and back of the house labor, which are semi-fixed in nature, increased as a percentage of sales due to the decline in sales.

On a year-to-date basis, labor and other related expenses increased as a percentage of restaurant sales 70 basis points to 33.2% compared with 32.5% for the 39-week period of fiscal year 2008. Again, the increase primarily reflects labor cost leverage that is lost when same-store sales decline.

Restaurant operating expenses, which primarily include rent, property taxes, utilities, repair and maintenance, liquor taxes, property insurance, general liability insurance and advertising, decreased as a percentage of restaurant sales 100 basis points to 25.9% as compared with 26.9% in the third quarter of fiscal year 2008. The decrease reflects lower electric and gas expenses of 150 basis points, lower marketing expenses of 80 basis points, offset by higher coupon, rent, insurance and property tax expenses for a combined increase of 124 basis points.

On a year-to-date basis, restaurant operating expenses increased 10 basis points to 25.3% compared with 25.2% for the 39-week period in fiscal year 2008. The increase primarily reflects the same that was discussed in the previous paragraph except the offsetting items were proportionally higher.

General and administrative expenses consist of expenses associated with corporate and administrative functions that support restaurant operations. As a percentage of total revenue, general and administrative expenses decreased 110

basis points to 8.8% for the third quarter of fiscal year 2009 as compared with 9.9% for the third quarter of fiscal year 2008. On a year-to-date basis, general and administrative expenses decreased 110 basis points to 8.8% compared with the 39-week period of fiscal 2008. In absolute dollars, general and administrative costs decreased \$224,098 and \$601,672 in the 13-week and 39-week periods of fiscal year 2009, respectively, compared with the same periods of fiscal year 2008. General and administrative expenses as a percentage of total revenues decreased due to the planned reduction in salaries, bonuses and most department expenses, partially offset by higher legal and stock compensation expense, both related to the sale of La Senorita.

Depreciation and amortization expense include the depreciation of fixed assets and the amortization of intangible assets. Depreciation and amortization expense increased as a percentage of total sales 60 basis points to 5.1% for the third quarter of fiscal year 2009 as compared with 4.5% the same quarter in fiscal year 2008. Such expense for the third quarter of fiscal year 2009 was \$86,463 higher than the third quarter in fiscal year 2008. The increase reflects additional depreciation expense for remodeled restaurants, new restaurants, and the replacement of equipment and leasehold improvements in various existing restaurants.

On a year-to-date basis, depreciation and amortization expenses increased as a percentage of total sales 40 basis points to 4.8% for the 39-week period of fiscal year 2009 as compared with 4.4% the same 39-week period of fiscal year 2008, or \$229,768 higher than the same 39-week period of fiscal year 2008. The increase was due to the reasons discussed above.

During the third quarter ended September 27, 2009, we opened a new Mission Burrito restaurant, incurring \$21,745 in pre-opening costs. During the third quarter of fiscal year 2008, we re-opened one Casa Olé restaurant that had been closed for repairs due to a fire, incurring \$43,810 in pre-opening costs.

Impairment and Restaurant Closure Costs. Long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

The consolidated statements of operations for the 13-week and 39-week periods ended September 27, 2009, include a separate line item for impairment and restaurant closure costs of \$116,937 and \$354,168, respectively. The impairments and closure costs were primarily related to rent differential adjustments for two subleased restaurants located in Idaho, asset impairments for the corporate office, and to a lesser extent, two under-performing restaurants operating in the Houston area. The consolidated statements of operations for the 13-week and 39-week periods ended September 28, 2008, include a separate line item for impairment and restaurant closure costs of \$67,597 and \$122,426, respectively. The impairments and closure costs were primarily related to the same two under-performing restaurants operating in the Houston area and the two Idaho subleased restaurants.

Loss (Gain) on Involuntary Disposals. The consolidated statements of operations for the 13-week and 39-week periods ended September 27, 2009 include a separate line item for a loss of \$18,330 and \$26,127 respectively. The losses resulted from costs related to our Hurricane Ike insurance claim, partially offset by insurance proceeds received for the replacement of assets. We are currently working with our insurance company to finalize all insurance claims related to the property damage from last year's hurricane. The consolidated statements of operations for the 13-week and 39-week periods ended September 28, 2008 includes a separate line item for a loss of \$140,938 and a gain of \$134,771, respectively, resulting from inventory losses caused by Hurricane Ike and the write-off of assets damaged by the February 2008 fire at the Company's Casa Olé restaurant located in Vidor, Texas, net of insurance proceeds for the replacement of assets. The claim related to the Vidor fire has been fully settled with the insurance company.

Loss on Sale of Other Property and Equipment. The consolidated statements of operations for the 13-week and 39-week periods ended September 27, 2009 include a separate line item for a loss of \$46,430 and \$120,126, respectively, primarily related to the routine disposal of restaurant assets. The consolidated statements of operations for the 13-week and 39-week periods ended September 28, 2008 includes a separate line item for a loss of \$131,509 and \$173,179, respectively, primarily related to the disposal of restaurant assets during the conversion of an existing restaurant into a Mission Burrito restaurant.

Other Income (Expense). Net expense decreased \$47,948 to \$32,313 in the 13-week period ended September 27, 2009 compared with a net expense of \$80,261 in the 13-week period ended September 28, 2008. Interest expense decreased \$52,133 to \$39,870 in the 13-week period ended September 27, 2009 compared with interest expense of \$92,003 in the 13-week period ended September 28, 2008. The decrease in interest expense reflects lower interest rates and lower average debt balances during the third quarter of fiscal year 2009 as compared to the third quarter of fiscal year 2008. Net expense decreased \$177,647 to \$115,459 in the 39-week period ending September 27, 2009 compared with a net expense of \$293,105 in the 39-week period ended September 28, 2008. Interest expense decreased \$180,234 to \$144,981 in the 39-week period ended September 27, 2009 compared with interest expense of \$325,215 in the 39-week period ended September 28, 2008. The decrease in interest expense reflects lower interest

rates and lower average debt balances during the 39-week period of fiscal year 2009 as compared to the 39-week period of fiscal year 2008.

Income Taxes. Our effective tax rate from continuing operations for the 13-week period ended September 27, 2009 was a benefit of 57.1% as compared to a benefit of 42.9% for the 13-week period ended September 28, 2008. Our effective tax rate from continuing operations for the 39-week period ended September 27, 2009 was a benefit of 59.2% as compared to a benefit of 65.7% for the 39-week period ended September 28, 2008. The decrease in the year-to-date effective rate is attributed primarily to an increase in FICA tip credits and other permanent differences. We did not have any discontinued operations during the 13-week period ended September 27, 2009. Our effective tax rate from discontinued operations for the 13-week period ended September 28, 2008 was an expense of 129.4%. Our effective tax rate from discontinued operations for the 39-week period ended September 27, 2009 was an expense of 121.4% as compared to an expense of 64.0% for the 39-week period ended September 28, 2008. The increase in the year-to-date effective rate is attributed to income tax expense related to the sale of our La Senorita chain in Michigan in addition to a capital loss related to the La Senorita sale that has been fully reserved.

Discontinued Operations. On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Seniorita restaurant chain (consisting of five site locations) located in Michigan for \$2,557,603 as adjusted under the terms of the purchase agreement. We recorded a gain on this sale of \$387,083, net of allocated goodwill, in the second quarter of 2009. Proceeds from the sale were used to pay down long-term debt. On January 24, 2009, we closed one underperforming Mission Burrito restaurant. The results of operations for the current and prior periods for the La Seniorita chain and the closed Mission Burrito restaurant have been reported as discontinued operations. For the 13-week period ended September 27, 2009, we did not have any discontinued operations. For the 39-week period ended September 27, 2009, we recognized net income from discontinued operations of \$231,582 from the sale of the chain and the closure of the Mission Burrito restaurant. Income from discontinued operations of \$36,021 during the 39-week period ended September 27, 2009 reflects operating income from the La Seniorita restaurants, partially offset by operating losses from the closed Mission Burrito restaurant. Restaurant closure costs of \$190,941, for the 39-week period ending September 27, 2009, primarily reflect costs associated with the closure of the Mission Burrito restaurant. Gain on sale of assets of \$386,502 during the 39-week period ended September 27, 2009 resulted primarily from the sale of La Seniorita.

The assets and liabilities related to the sale of the La Seniorita chain that were sold have been classified as held for sale in the consolidated balance sheet as of December 28, 2008. The assets and liabilities of the Mission Burrito restaurant and certain assets and liabilities of La Seniorita that were not sold have been classified as related to discontinued operations. We used the furniture and equipment from the closed Mission Burrito restaurant at our new Mission Burrito restaurant that we opened third quarter. Current liabilities related to discontinued operations of the closed Mission Burrito restaurant include estimated lease obligations and are included with current portion of liabilities associated with leasing and exit activities.

Liquidity and Capital Resources

We financed our capital expenditure requirements for the 39-week period ended September 27, 2009 primarily from our operating cash flows. In the 39-week period of fiscal year 2009, we had cash flows provided by operating activities of approximately \$1.8 million, compared with cash flows provided by operating activities of approximately \$1.2 million in the comparable 39-week period of fiscal year 2008. The increase in cash flows from operating activities reflects the receipt of insurance receivables related to last year's hurricanes and the Pasadena, Texas restaurant fire. During the 39-week period ended September 27, 2009, we made draws of \$900,000 and payments of \$3,250,000 on our line of credit. Proceeds from the sale of La Seniorita contributed to the amount paid on the line of credit. As of September 27, 2009, we had a working capital deficit of \$994,215 compared with a working capital deficit (excluding assets held for sale) of \$1,023,766 at December 28, 2008. 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.

Our principal capital requirements are the funding of routine capital expenditures, new restaurant development or acquisitions and remodeling of older units. During the 39-week period ended September 27, 2009, total cash used for capital requirements was \$2,777,570 with \$2,762,320 used in continuing operations and \$15,250 used in discontinued operations. Total cash used for capital requirements included \$1,835,598 spent for routine capital expenditures, \$540,155 for new restaurant development, \$76,394 for replacement of damaged assets and \$325,422 for remodels. We opened one new restaurant during the third quarter of fiscal year 2009. We do not plan to open any new restaurants during the remainder of fiscal year 2009. We anticipate that we will spend approximately \$400,000 for capital expenditures during the remainder of fiscal year 2009.

We entered into a Credit Agreement with Wells Fargo Bank, N.A. ("Wells Fargo") in June 2007 (the "Wells Fargo Agreement"). Originally, the Wells Fargo Agreement provided for a revolving loan of up to \$10 million, but the Wells Fargo Agreement was amended effective December 28, 2008, reducing the revolving loan by the amount of the net proceeds received from the sale of La Seniorita, which reduced the revolver availability to approximately \$7.3 million on April 7, 2009. Effective June 28, 2009, the Wells Fargo Agreement was further amended primarily to extend the

maturity date from June 29, 2010 to June 29, 2012. The June 2009 amendment to the Wells Fargo Agreement also increased the stipulated percentages payable in connection with London Interbank Offered Rate (“LIBOR”) loans and letters of credit under the Wells Fargo Agreement, added as a condition precedent to loans made to the Company for growth capital expenditures that the Company’s total leverage ratio not exceed certain stated amounts, and amended certain financial covenants.

At our option, the revolving loan bears an interest rate equal to the Wells Fargo Base Rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, we are impacted by changes in the Base Rate and LIBOR. We are subject to a non-use fee of 0.50% on the unused portion of the revolver from the date of the Wells Fargo Agreement. The Wells Fargo Agreement also allows up to \$2.0 million in annual stock repurchases. We have pledged the stock of our subsidiaries, our leasehold interests, our patents and trademarks and our furniture, fixtures and equipment as collateral for our credit facility with Wells Fargo.

Although the Wells Fargo Agreement permits us to implement a share repurchase program for up to \$2.0 million annually under certain conditions, we currently have no repurchase programs in effect. Shares previously acquired are being held for general corporate purposes, including the offset of the dilutive effect on shareholders from the exercise of stock options.

On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Seniorita restaurant chain (consisting of five site locations) located in Michigan for an adjusted price of \$2.6 million. Proceeds from the sale were used to pay down long-term debt. We recorded a gain on the sale of La Seniorita of \$387,083 in the second quarter of 2009.

Our management believes that with our operating cash flows and our revolving line of credit under the Wells Fargo Agreement, funds will be sufficient to meet operating requirements and to finance routine capital expenditures and new restaurant growth through the next 12 months. Unless we violate a debt covenant, our credit facility with Wells Fargo, as amended, is not subject to triggering events that would cause the credit facility to become due sooner than the maturity date described in the previous paragraphs. As of September 27, 2009, the Company was in compliance with all debt covenants and as of the date hereof expects to be in compliance with its debt covenants during the next 12 months, although we continue to closely monitor the impact of the continued deterioration of the casual dining market on our operating results.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk from changes in interest rates on debt and changes in commodity prices. Our exposure to interest rate fluctuations is limited to outstanding bank debt. At September 27, 2009, there was \$5.15 million outstanding under the revolving credit facility which currently bears interest at 275 basis points (depending on leverage ratios) over LIBOR. Should interest rates based on these borrowings increase by one percentage point, estimated quarterly interest expense would increase by \$12,875.

Effects of Inflation

Components of our operations subject to inflation include food, beverage, lease and labor costs. Our leases require us to pay taxes, maintenance, repairs, insurance and utilities, all of which are subject to inflationary increases. We believe inflation in the costs of various items has had a material impact on our results of operations in recent years.

Commodity Price Risk

We are exposed to market price fluctuations in beef, chicken, pork, dairy products, produce, tortillas and other food product prices. Given the historical volatility of these product prices, this exposure can impact our food and beverage costs. Because we typically set our menu prices in advance of these product purchases, we cannot quickly take into account changing costs. To the extent that we are unable to pass the increased costs on to our guests through price increases, our results of operations would be adversely affected. We currently do not use financial instruments to hedge our risk to market price fluctuations in food product prices.

Interest Rates

We do not have, or participate in, any transactions involving derivative, financial and commodity instruments. Our long-term debt bears interest at floating market rates, based upon either the prime rate or LIBOR plus a stipulated percentage, and therefore we experience changes in interest expense when market interest rates change.

The subprime mortgage crisis, subsequent disruptions to the financial markets, and continuing economic downturn may adversely impact the availability of credit already arranged and the availability and cost of credit in the future. The disruptions in the financial markets have had an adverse effect on the U.S. and world economy, and have

negatively impacted recent consumer spending patterns. There can be no assurance that various U.S. and world government responses to the disruptions in the financial markets in the near future will restore consumer confidence, stabilize the markets, or increase liquidity or the availability of credit. Our future performance could be hindered by our accessibility to obtain financing.

Item 4T. Controls and Procedures

Evaluation of Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the “Exchange Act”)) that are designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (“CEO”) and Chief Financial Officer (“CFO”), as appropriate, to allow timely decisions regarding required disclosures.

We evaluated the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this report. Based on the evaluation, performed under the supervision and with the participation of management, including our CEO and CFO, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of the period covered by this report.

Changes in Internal Control Over Financial Reporting

During the last quarterly period covered by this report, there were no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that materially affected or are reasonably likely to materially affect our internal control over financial reporting.

PART II - OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the Company’s risk factors from the disclosure set forth in our Annual Report on Form 10-K for the fiscal year ended December 28, 2008.

You should carefully consider the risk factors set forth in our Annual Report on Form 10-K and the other information set forth in the Annual Report in Form 10-K and this Quarterly Report on Form 10-Q. You should be aware that these risk factors and other information may not describe every risk facing us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 6. Exhibits

Exhibit

Number

Document Description

| | |
|-------------|---|
| <u>31.1</u> | <u>Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| <u>31.2</u> | <u>Certification of Chief Financial Officer Pursuant to Section 302 of the</u> |

Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 1, 2, 3, 4 and 5 of this Part II are not applicable and have been omitted.

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.

Mexican Restaurants, Inc.

Dated: November 12, 2009
Curt Glowacki
Chief Executive Officer
(Principal Executive Officer)

By: /s/ Curt Glowacki

Dated: November 12, 2009

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

By: /s/ Andrew J.
Dennard

