

MEXICAN RESTAURANTS INC  
Form 10-Q  
August 17, 2010

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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 July 4, 2010

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)

12000 Aerospace Ave. Suite 400, Houston,  
Texas  
(Address of Principal Executive Offices)

77034  
(Zip Code)

Registrant's telephone number, including area code: 832-300-5858

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 August 13, 2010: 3,413,099 shares, par value \$.01.

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## PART 1 - FINANCIAL INFORMATION

## Item 1. Financial Statements

Mexican Restaurants, Inc. and Subsidiaries  
Consolidated Balance Sheets

	(Unaudited) 7/4/2010	1/3/2010
<b>ASSETS</b>		
Current assets:		
Cash	\$ 569,857	\$ 719,944
Royalties receivable	84,116	61,194
Other receivables	526,275	639,019
Inventory	578,694	562,682
Income taxes receivable	--	284,724
Prepaid expenses and other current assets	856,159	1,065,056
Assets related to discontinued operations	211,646	161,523
Total current assets	2,826,747	3,494,142
Property and equipment, net	16,846,986	17,491,335
Goodwill	5,017,243	5,017,243
Deferred tax assets	1,977,305	1,542,999
Other assets	122,588	147,667
Other assets related to discontinued operations	33,878	33,878
Total Assets	\$ 26,824,747	\$ 27,727,264
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 2,534,032	\$ 1,929,864
Accrued sales, liquor, and payroll taxes	884,304	979,735
Accrued expenses	744,902	1,104,185
Income taxes payable	214,605	--
Current liabilities related to discontinued operations	18,056	39,554
Current portion of liabilities associated with leasing and exit activities	160,045	107,381
Total current liabilities	4,555,944	4,160,719
Long-term debt	4,050,000	5,150,000
Liabilities associated with leasing and exit activities, net of current portion	670,867	611,392
Deferred gain	624,429	728,500
Deferred rent and other liabilities	2,145,364	2,149,313
Total Liabilities	12,046,604	12,799,924

## Commitments &amp; Contingencies

## 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, 3,413,099 and 3,290,041 shares outstanding at 7/4/2010 and 1/3/2010, respectively	47,327	47,327
Additional paid-in capital	18,653,767	19,390,702
Retained earnings	7,770,516	8,272,186
Treasury stock, at cost, 1,319,606 and 1,442,564 common shares at 7/4/10 and 1/3/10, respectively	(11,693,467)	(12,782,875)
Total stockholders' equity	14,778,143	14,927,340
Total Liabilities and Stockholders' Equity	\$ 26,824,747	\$ 27,727,264

See accompanying notes to consolidated financial statements.

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

	13-Week Period Ended 7/4/2010	13-Week Period Ended 6/28/2009	26-Week Period Ended 7/4/2010	26-Week Period Ended 6/28/2009
<b>Revenues:</b>				
Restaurant sales	\$ 16,921,142	\$ 18,107,695	\$ 33,774,217	\$ 37,121,251
Franchise fees, royalties and other	117,776	126,578	241,688	264,867
Business interruption	--	103,528	--	103,528
	17,038,918	18,337,801	34,015,905	37,489,646
<b>Costs and expenses:</b>				
Cost of sales	4,954,217	5,263,291	9,899,129	10,513,537
Labor	5,734,905	6,050,108	11,551,991	12,173,097
Restaurant operating expenses	4,387,496	4,522,659	8,772,384	9,304,997
General and administrative	1,251,211	1,632,038	2,699,712	3,318,767
Depreciation and amortization	862,780	885,013	1,721,146	1,752,970
Impairment and restaurant closure expense	6,197	214,778	11,418	237,231
Loss on involuntary disposals	--	15,028	--	7,797
Loss on sale of property and equipment	9,663	36,934	13,378	73,696
	17,206,469	18,619,849	34,669,158	37,382,092
Operating income (loss)	(167,551 )	(282,048 )	(653,253 )	107,554
<b>Other income (expense):</b>				
Interest income	563	883	12,346	1,863
Interest expense	(44,599 )	(42,918 )	(106,368 )	(105,111 )
Other, net	5,945	9,601	24,513	20,102
	(38,091 )	(32,434 )	(69,509 )	( 83,146 )
Income (loss) from continuing operations before income taxes	(205,642 )	(314,482 )	(722,762 )	24,408
Income tax (expense) benefit	103,118	62,825	324,808	(2,983 )
Income (loss) from continuing operations	(102,524 )	(251,657 )	(397,954 )	21,425
<b>Discontinued Operations:</b>				
Income (loss) from discontinued operations	--	(39,436 )	--	36,021
Restaurant closure expense	--	(369 )	(181,543 )	(190,941 )
Gain on sale of assets	--	387,083	--	386,502
Income (loss) from discontinued operations before income taxes	--	347,278	(181,543 )	231,582
Income tax (expense) benefit	--	(303,558 )	77,827	(281,090 )
Income (loss) from discontinued operations	--	43,720	(103,716 )	(49,508 )

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Net loss	\$ (102,524 )	\$ (207,937 )	\$ (501,670 )	\$ (28,083 )
Basic income (loss) per common share				
Income (loss) from continuing operations	\$ (0.03 )	\$ ( 0.07 )	\$ (0.12 )	\$ 0.01
Income (loss) from discontinued operations	--	0.01	(0.03 )	(0.02 )
Net loss	\$ (0.03 )	\$ (0.06 )	\$ (0.15 )	\$ (0.01 )
Diluted income (loss) per common share				
Income (loss) from continuing operations	\$ (0.03 )	\$ (0.07 )	\$ (0.12 )	\$ 0.01
Income (loss) from discontinued operations	--	0.01	(0.03 )	(0.02 )
Net loss	\$ (0.03 )	\$ (0.06 )	\$ (0.15 )	\$ (0.01 )
Weighted average number of common shares (basic)	3,423,148	3,284,641	3,366,388	3,271,358
Weighted average number of common shares (diluted)	3,423,148	3,284,641	3,366,388	3,272,981

See accompanying notes to consolidated financial statements.



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

	26-Week Period Ended 7/4/2010	26-Week Period Ended 6/28/2009
Cash flows from operating activities:		
Net loss	\$(501,670 )	\$(28,083 )
Loss from discontinued operations	103,716	49,508
Income (loss) from continuing operations	(397,954 )	21,425
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	1,721,146	1,752,970
Deferred gain amortization	(104,071 )	(104,071 )
Impairment and restaurant closure expense	11,418	237,231
Other non-cash income	(16,454 )	--
Loss on involuntary disposals	--	7,797
Loss on sale of property & equipment	13,378	73,696
Stock based compensation expense	88,106	185,566
Excess tax benefit-stock based compensation expense	13,605	39,751
Deferred income tax expense (benefit)	(434,306 )	115,866
Changes in operating assets and liabilities, net of effects of business acquisitions:		
Royalties receivable	(22,922 )	69,195
Other receivables	112,744	319,204
Inventory	(16,012 )	16,133
Income taxes receivable	563,551	80,057
Prepaid and other current assets	208,897	(115,290 )
Other assets	3,803	8,063
Accounts payable	604,168	(272,480 )
Accrued expenses and other liabilities	(454,714 )	(636,889 )
Liabilities associated with leasing and exit activities	(69,404 )	239,233
Deferred rent and other long-term liabilities	(3,949 )	(38,751 )
Total adjustments	2,218,984	1,977,281
Net cash provided by continuing operations	1,821,030	1,998,706
Net cash used in discontinued operations	(71,621 )	(402,786 )
Net cash provided by operating activities	1,749,409	1,595,920
Cash flows from investing activities:		
Insurance proceeds received from involuntary disposals	--	54,731
Purchase of property and equipment	(1,070,887)	(1,667,143)
Proceeds from landlord for lease buildout	--	75,000
Proceeds from sale of property and equipment	7,024	--
Net cash used in continuing operations	(1,063,863)	(1,537,412)
Purchase of property and equipment	--	(15,250 )
Business divestitures, net proceeds (sale of La Seniorita)	--	2,557,603
Net cash provided by discontinued operations	--	2,542,353
Net cash provided by (used in) investing activities	(1,063,863)	1,004,941
Cash flows from financing activities:		

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Borrowings under line of credit agreement	900,000	600,000
Payments under line of credit agreement	(2,000,000)	(3,250,000)
Issuance of common stock from treasury	277,972	--
Excess tax expense – stock-based compensation expense	(13,605 )	(39,751 )
Net cash used in financing activities	(835,633 )	(2,689,751)
Net decrease in cash	(150,087 )	(88,890 )
Cash at beginning of period	719,944	879,206
Cash at end of period	\$569,857	\$790,316
Supplemental disclosure of cash flow information:		
Cash paid during the period:		
Interest	\$96,452	\$115,141
Income taxes	\$145,000	\$90,672

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 July 4, 2010, and the consolidated statements of operations and cash flows for the 13-week and 26-week periods ended July 4, 2010 and June 28, 2009. The consolidated statements of operations for the 13-week and 26-week periods ended July 4, 2010 and June 28, 2009 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 January 3, 2010 filed with the Securities and Exchange Commission on April 1, 2010. 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.

2. Income Taxes

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 July 4, 2010, we had one equity-based compensation plan from which stock-based compensation awards can be granted to eligible employees, officers and directors, known as the 2005 Long Term Incentive Plan. A total of 425,000 shares have been authorized for issuance under this plan. The Company’s 1996 Long Term Incentive Plan, its Stock Option Plan for Non-Employee Directors and its 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 January 3, 2010.

On May 22, 2009, restricted stock grants in the amount of 10,000 shares to the Company’s President were granted pursuant to a May 22, 2007 agreement, with such shares vesting over a four-year period.

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On December 15, 2009, restricted stock grants in the amount of 10,000 shares to one employee were granted pursuant to a December 15, 2006 agreement, with such shares vesting over a five-year period.

On May 24, 2010, restricted stock grants in the amount of 10,000 shares to the Company's President were granted pursuant to a May 22, 2007 agreement, with such shares vesting over a four-year period.

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 and 26-week periods ended July 4, 2010 and June 28, 2009.

#### 4. Income (Loss) per Share

Basic income (loss) per share is based on the weighted average shares outstanding without any dilutive effects considered. Diluted income (loss) 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 period ended July 4, 2010, weighted-average shares outstanding, assuming dilution, excludes the impact of 5,698 common stock equivalents due to our net loss position in the period. For the 26-week period ended July 4, 2010, weighted-average shares outstanding, assuming dilution, excludes the impact of 1,877 common stock equivalents due to our net loss position in the period. For the 13-week period ended June 28, 2009, weighted-average shares outstanding, assuming dilution, no common stock equivalents were included because the sum of the assumed proceeds, including the unrecognized compensation costs calculated under the treasury stock method, exceeded the average stock price. For the 26-week period ended June 28, 2009, weighted-average shares outstanding, assuming dilution, includes 1,623 common stock equivalents.

#### 5. Long-term Debt

We entered into a Credit Agreement with Wells Fargo Bank, N.A. (“Wells Fargo”) in June 2007 (as amended, the “Wells Fargo Agreement”). The Wells Fargo Agreement provides for a revolving loan of up to approximately \$7.3 million, and has a maturity date of June 29, 2012. Effective January 3, 2010, the Wells Fargo Agreement was amended primarily to allow for the add-back of severance expense of \$190,000 that the Company incurred as part of its reduction in general and administrative expense to the Company’s calculation of rolling twelve-month cash flow. The January 3, 2010 amendment also reduced the revolver availability to \$6.0 million effective July 4, 2010. Effective April 4, 2010, the Wells Fargo Agreement was further amended to reduce the fixed charge coverage ratio from 1.20 to 1.10 through the first quarter of fiscal year 2011 and to increase the interest rate 50 basis points to LIBOR plus 325 basis points. For the second quarter of fiscal year 2011 and thereafter the fixed charge coverage ratio is increased to 1.20 and the interest rate remains at LIBOR plus 325 basis points. We were in compliance with all debt covenants of the Wells Fargo Agreement at July 4, 2010.

At our option, the revolving loan bears an interest rate equal to the Wells Fargo stated base rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, we are impacted by changes in the Wells Fargo 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 July 4, 2010 and June 28, 2009, the Company recognized royalty income of \$5,755 and \$6,138, respectively, related to this restaurant. For the 26-week periods ended July 4, 2010 and June 28, 2009, the Company recognized royalty income of \$11,337 and \$12,249, respectively, related to this restaurant.

On March 31, 2010 we sold 113,458 shares of common stock from our treasury shares to Michael D. Domec, a director of the Company and our largest shareholder, for \$277,972 or \$2.45 per share. The per share price was based upon a weighted average based on the preceding 30 days, and the transaction was exempt from registration under

Section 4(2) of the Securities Act of 1933. We used the proceeds to pay down on our line of credit under the Wells Fargo Agreement.

7. Discontinued Operations

The results of operations, assets and liabilities for all units that have been disposed of are reclassified to discontinued operations in the consolidated statements of operations and balance sheets for all periods presented.

Current assets and liabilities related to discontinued operations consist primarily of rent receivable and property taxes for a closed restaurant for which we have subleased the restaurant.

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During the first quarter of fiscal year 2010, we recognized \$181,543 of restaurant closure expense related to a subleased store that we have entered into negotiations with to reduce the aggregate future rent receipts under the terms of a proposed amendment to the sublease.

On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Senorita restaurant chain (consisting of five site locations) located in Michigan for \$2,557,603 as adjusted under the terms of the purchase agreement. For the 13-week and 26-week periods ended June 28, 2009, we recognized a gain on this sale of \$387,083 and \$386,502, respectively, net of allocated goodwill. 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 fiscal year 2009 for the La Senorita chain and the closed Mission Burrito restaurant have been reported as discontinued operations. During the 13-week and 26-week periods ended June 28, 2009, we recognized a loss from discontinued operations of \$39,436 and income from discontinued operations of \$36,021, respectively, from the sale of the chain and the closure of the Mission Burrito restaurant. Restaurant closure expense of \$369 and \$190,941 for the 13-week and 26-week periods ended June 28, 2009, respectively, primarily reflect costs associated with the closure of the Mission Burrito restaurant.

#### 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

We evaluated all subsequent events and transactions through the issuance date of our consolidated financial statements. No unrecognized subsequent events or transactions were noted.

### 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 and Crazy Jose's. We also operate fast casual burrito restaurants under the name Mission Burrito. At July 4, 2010, we operated 55 restaurants, franchised 16 restaurants and licensed one restaurant in various communities in Texas, Louisiana and Oklahoma. During the second quarter of 2010 one underperforming Casa Olé franchise location was closed.

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.



In October 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 restaurant revenues for the 13-week and 26-week periods of fiscal year 2010 decreased \$1.2 million or 6.6% and \$3.3 million or 9.0% to \$16.9 and \$33.8 million, respectively, compared with revenues of \$18.1 and \$37.1 million for the same respective periods in fiscal year 2009. The decrease in restaurant revenues primarily reflects a decrease in same-store sales. For the 13-week and 26-week periods ended July 4, 2010, Company-owned same-restaurant sales decreased approximately 7.1% and 9.4%, respectively. Franchised-owned restaurant sales, as reported by franchisees, decreased approximately 6.6% and 8.8%, respectively, over the same respective periods in fiscal 2009. We believe such decreases are a result of the continued weakness in the economy and its impact on consumers' dining habits.

**Costs and Expenses.** Costs of sales, consisting of food, beverage, liquor, supplies and paper costs, was 29.3% as a percentage of restaurant sales for the 13-week and 26-week periods of fiscal year 2010 compared with 29.1% and 28.3%, respectively, for the same respective periods of fiscal year 2009. The increase reflects higher comparative produce and soft beverage costs. Further, food discounts, which reduce cost of sales by reclassing the cost of food discounts to controllable expenses, were approximately \$200,000 and \$700,000 lower in the 13-week and 26-week periods for fiscal year 2010 compared with the same respective periods of fiscal year 2009, resulting in a 20 and 100 basis point increase, respectively, in cost of sales. In absolute dollars, cost of sales decreased \$309,074 and \$614,408, respectively, compared with the 13-week and 26-week periods of fiscal year 2009.

Labor and other related expenses for the 13-week and 26-week periods of fiscal 2010 increased as a percentage of restaurant sales 50 and 140 basis points to 33.9% and 34.2%, respectively, as compared with 33.4% and 32.8%, respectively, for the 13-week and 26-week periods of fiscal year 2009. The increase reflects labor cost leverage that is lost when same-store sales decline. The increase in labor also reflects our investment in the Starship Initiative, a program designed to retrain each restaurant's staff to perform at a higher level of hospitality, service and food quality standards. In absolute dollars, labor and other related expenses decreased \$315,203 and \$621,106, respectively, compared with the 13-week and 26-week periods of fiscal year 2009.

Restaurant operating expenses, which primarily include rent, property taxes, utilities, repair and maintenance, liquor taxes, property insurance, general liability insurance and advertising, increased as a percentage of restaurant sales 90 basis points to 25.9% and 26.0%, respectively, for the 13-week and 26-week periods of fiscal 2010 as compared with 25.0% and 25.1%, respectively, in the 13-week and 26-week periods of fiscal year 2009. The increase reflects cost leverage that is lost when same-store sales decline. Offsetting some of the increase, 13-week and 26-week period utilities and advertising expenses were approximately \$100,000 and \$350,000 lower, respectively, than the 13-week and 26-week periods of fiscal year 2009. In absolute dollars, restaurant operating expenses decreased \$135,163 and \$532,613, respectively, compared with the 13-week and 26-week periods of fiscal year 2009.

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 160 and 100 basis points, respectively, to 7.3% and 7.9% for the 13-week and 26-week periods of fiscal year 2010 as compared with 8.9% for the 13-week and 26-week periods of fiscal year 2009. In absolute dollars, general and administrative costs decreased \$380,827 and \$619,055, respectively, compared with the 13-week and 26-week periods of fiscal year 2009. General and administrative expenses decreased both as a percentage of total revenues and in

absolute dollars due to the previously planned reductions in salaries, bonuses and most department expenses.

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 30 and 40 basis points, respectively, to 5.1% for the 13-week and 26-week periods of fiscal year 2010 as compared with 4.8% and 4.7%, respectively, for the 13-week and 26-week periods in fiscal year 2009. Such expense for the 13-week and 26-week periods of fiscal year 2010 were \$22,233 and \$31,824 lower, respectively, than for the 13-week and 26-week periods in fiscal year 2009.

**Impairment and Restaurant Closure Expense.** 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 26-week periods ended July 4, 2010, includes a separate line item for impairment and restaurant closure expense of \$6,197 and \$11,418, respectively, primarily related to two under-performing restaurants operating in the Houston area. The consolidated statements of operations for the 13-week and 26-week periods ended June 28, 2009, includes a separate line item for impairment and restaurant closure expense of \$214,778 and \$237,231, respectively, primarily related to renegotiated sub-leases for two properties in Idaho and the two under-performing restaurants operating in the Houston area.

**Loss on Involuntary Disposals.** The consolidated statements of operations for the 13-week and 26-week periods ended June 28, 2009 include a separate line item for a loss of \$15,028 and \$7,797, respectively, primarily related to the Hurricane Ike insurance claim.

**Loss on Sale of Property and Equipment.** The consolidated statements of operations for the 13-week and 26-week periods ended July 4, 2010 include a separate line item for a loss of \$9,663 and \$13,378, respectively, primarily related to the routine disposal of restaurant assets. The consolidated statements of operations for the 13-week and 26-week periods ended June 28, 2009 include a separate line item for a loss of \$36,934 and \$73,696, respectively, primarily related to the routine disposal of restaurant assets.

**Other Income (Expense).** Net expense increased \$5,657 to \$38,091 in the 13-week period ended July 4, 2010 compared with a net expense of \$32,434 in the 13-week period ended June 28, 2009. Interest expense increased \$1,681 to \$44,599 in the 13-week period ended July 4, 2010 compared with interest expense of \$42,918 in the 13-week period ended June 28, 2009. Average debt was approximately \$2.0 million lower in the 13-week period of fiscal year 2010 compared with the 13-week period of fiscal year 2009. The small increase in interest expense reflects higher interest rates in the second quarter of fiscal year 2010 compared with interest rates in the second quarter of fiscal year 2009 offset by lower average debt outstanding for the 2010 second quarter.

Net expense decreased \$13,637 to \$69,509 in the 26-week period ended July 4, 2010 compared with a net expense of \$83,146 in the 26-week period ended June 28, 2009. Interest expense increased \$1,257 to \$106,368 in the 26-week period ended July 4, 2010 compared with interest expense of \$105,111 in the 26-week period ended June 28, 2009. Average debt was approximately \$1.5 million lower in the first half of fiscal year 2010 compared with the first half of 2009. The small increase in interest expense reflects higher interest rates in the first half of fiscal year 2010 compared with interest rates in the first half of fiscal year 2009 offset by lower average debt outstanding for the first half of 2010.

**Income Taxes.** Our effective tax rate from continuing operations for the 13-week period ended July 4, 2010 was a benefit of 50.1% as compared to a benefit of 20.0% for the 13-week period ended June 28, 2009. The increase in the effective rate is attributed primarily to the net loss before income taxes and an increase in permanent differences related to FICA tip credits for the 13-week period ended July 4, 2010. Our effective tax rate from discontinued operations for the 13-week period ended June 28, 2009 was an expense of 87.4% primarily related to the sale of our La Senorita chain in April 2009.

Our effective tax rate from continuing operations for the 26-week period ended July 4, 2010 was a benefit of 44.9% as compared to an expense of 12.2% for the 26-week period ended June 28, 2009. The increase in the effective rate is attributed primarily to the net loss before income taxes and an increase in permanent differences related to FICA tip

credits for the 26-week period ended July 4, 2010. Our effective tax rate from discontinued operations for the 26-week period ended July 4, 2010 was a benefit of 42.9% as compared to an expense of 121.4% for the 26-week period ended June 28, 2009. The decrease in the effective rate is attributed primarily to the net income before income taxes during fiscal year 2009 primarily related to the sale of our La Senorita chain in April 2009.

**Discontinued Operations.** During the first quarter of fiscal year 2010, we recognized \$181,543 of restaurant closure expense related to a subleased store that we have entered into negotiations with to reduce the aggregate future rent receipts under the terms of a proposed amendment to the sublease.

On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Senorita restaurant chain (consisting of five site locations) located in Michigan for \$2,557,603 as adjusted under the terms of the purchase agreement. For the 13-week and 26-week periods ended June 28, 2009, we recognized a gain on this sale of \$387,083 and \$386,502, respectively, net of allocated goodwill. 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 fiscal year 2009 for the La Senorita chain and the closed Mission Burrito restaurant have been reported as discontinued operations. During the 13-week and 26-week periods ended June 28, 2009, we recognized a loss from discontinued operations of \$39,436 and income from discontinued operations of \$36,021, respectively, from the sale of the chain and the closure of the Mission Burrito restaurant. Restaurant closure expense of \$369 and \$190,941 for the 13-week and 26-week periods ended June 28, 2009, respectively, primarily reflect costs associated with the closure of the Mission Burrito restaurant.

#### Liquidity and Capital Resources

We financed our capital expenditure requirements for the 26-week period ended July 4, 2010 primarily from our operating cash flows. In the 26-week period of fiscal year 2010, we had cash flows provided by operating activities of approximately \$1.7 million, compared with cash flows provided by operating activities of approximately \$1.6 million in the comparable 26-week period of fiscal year 2009. During the 26-week period ended July 4, 2010, we made draws of \$900,000 and payments of \$2.0 million on our line of credit. Proceeds from the sale of common stock from Treasury in the amount of \$277,972 contributed to the amount paid on the line of credit. As of July 4, 2010, we had a working capital deficit of approximately \$1.7 million compared with a working capital deficit of approximately \$700,000 at January 3, 2010. 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 26-week period ended July 4, 2010, total cash used for capital requirements, net of proceeds from sale of property and equipment, was \$1,063,863, all used for continuing operations. Total cash used for capital requirements included \$1,048,283 spent for routine capital expenditures and \$22,604 for the remodel of the new corporate office space. We received \$7,024 for the sale of miscellaneous restaurant equipment. We do not plan to open any new restaurants during the remainder of fiscal year 2010. We anticipate that we will spend approximately \$1.0 million for capital expenditures on current facilities during the remainder of fiscal year 2010.

We entered into a Credit Agreement with Wells Fargo Bank, N.A. ("Wells Fargo") in June 2007 (as amended, the "Wells Fargo Agreement"). The Wells Fargo Agreement provides for a revolving loan of up to approximately \$7.3 million, and has a maturity date of June 29, 2012. Effective January 3, 2010, the Wells Fargo Agreement was amended primarily to allow for the add-back of severance expense of \$190,000 that the Company incurred as part of its reduction in general and administrative expense to the Company's calculation of rolling twelve-month cash flow. The January 3, 2010 amendment also reduced the revolver availability to \$6.0 million effective July 4, 2010. Effective April 4, 2010, the Wells Fargo Agreement was further amended to reduce the fixed charge coverage ratio from 1.20 to 1.10 through the first quarter of fiscal year 2011 and to increase the interest rate 50 basis points to LIBOR plus 325 basis points. For the second quarter of fiscal year 2011 and thereafter the fixed charge coverage ratio is increased to 1.20 and the interest rate remains at LIBOR plus 325 basis points. As amended, we were in compliance with all debt covenants of the Wells Fargo Agreement at July 4, 2010.

At our option, the revolving loan bears an interest rate equal to the Wells Fargo stated base rate plus a stipulated percentage or LIBOR plus a stipulated percentage. Accordingly, we are impacted by changes in the Wells Fargo 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. 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.

In April 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 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 July 4, 2010, 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 July 4, 2010, there was \$4.05 million outstanding under the Wells Fargo revolving credit facility which currently bears interest at 325 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 approximately \$10,000.

#### 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 continuing disruptions to the financial markets and 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 January 3, 2010.

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 Filed Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
<u>31.2</u>	<u>Certification of Chief Financial Officer Filed Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>
<u>32.1</u>	<u>Certification of Chief Executive Officer Forwarded Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>
<u>32.2</u>	<u>Certification of Chief Financial Officer Forwarded Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>

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: August 17, 2010 By: /s/  
C u r t  
Glowacki

Curt Glowacki  
Chief Executive Officer  
(Principal Executive  
Officer)

Dated: August 17, 2010 By: /s/ Andrew J.  
Dennard

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

