

MORGANS FOODS INC  
Form 10-Q  
December 20, 2013

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, DC 20549**

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended November 10, 2013

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 1-08395**

**Morgan's Foods, Inc.**

(Exact name of registrant as specified in its charter)

Ohio  
(State or other jurisdiction of incorporation or organization)

34-0562210  
(I.R.S. Employer Identification No.)

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4829 Galaxy Parkway, Suite S, Cleveland, Ohio  
(Address of principal executive offices)

44128  
(Zip Code)

(216) 359-9000  
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  
Yes 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 "accelerated filer", "large accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

|                         |                                               |
|-------------------------|-----------------------------------------------|
| Large accelerated filer | Accelerated filer                             |
| Non-accelerated filer   | (do not check if a smaller reporting company) |
|                         | 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

As of December 18, 2013, the issuer had 4,048,147 common shares outstanding.

**PART I – FINANCIAL INFORMATION****Item 1. Financial Statements**

MORGAN'S FOODS, INC.

**CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)**

|                                                       | <b>Quarter Ended</b>         |                             |
|-------------------------------------------------------|------------------------------|-----------------------------|
|                                                       | <b>November<br/>10, 2013</b> | <b>November<br/>4, 2012</b> |
| Revenues                                              | \$ 19,050,000                | \$ 20,060,000               |
| Cost of sales:                                        |                              |                             |
| Food, paper and beverage                              | 6,137,000                    | 6,466,000                   |
| Labor and benefits                                    | 5,448,000                    | 5,747,000                   |
| Restaurant operating expenses                         | 4,635,000                    | 5,073,000                   |
| Depreciation and amortization                         | 707,000                      | 644,000                     |
| General and administrative expenses                   | 1,068,000                    | 1,140,000                   |
| Loss on restaurant assets                             | 205,000                      | 106,000                     |
| Operating income                                      | 850,000                      | 884,000                     |
| Interest expense:                                     |                              |                             |
| Bank debt and notes payable                           | 127,000                      | 200,000                     |
| Capital leases                                        | 465,000                      | 504,000                     |
| Other (income) and expense, net                       | 372,000                      | (16,000 )                   |
| Unrealized loss on derivatives                        | 130,000                      | -                           |
| Income (loss) before income taxes                     | (244,000 )                   | 196,000                     |
| Provision for income taxes                            | 63,000                       | 71,000                      |
| Net income (loss)                                     | \$(307,000 )                 | \$ 125,000                  |
| Basic net income (loss) per common share:             | \$(0.08 )                    | \$ 0.04                     |
| Diluted net income (loss) per common share:           | \$(0.08 )                    | \$ 0.04                     |
| Basic weighted average number of shares outstanding   | 4,044,147                    | 2,934,995                   |
| Diluted weighted average number of shares outstanding | 4,044,147                    | 2,984,694                   |

See notes to these consolidated financial statements.



## MORGAN'S FOODS, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS  
(UNAUDITED)

|                                                       | <b>Thirty-six Weeks Ended</b> |                         |
|-------------------------------------------------------|-------------------------------|-------------------------|
|                                                       | <b>November 10, 2013</b>      | <b>November 4, 2012</b> |
| Revenues                                              | \$ 59,732,000                 | \$ 61,016,000           |
| Cost of sales:                                        |                               |                         |
| Food, paper and beverage                              | 19,482,000                    | 19,769,000              |
| Labor and benefits                                    | 17,049,000                    | 17,261,000              |
| Restaurant operating expenses                         | 14,759,000                    | 15,333,000              |
| Depreciation and amortization                         | 2,071,000                     | 1,869,000               |
| General and administrative expenses                   | 3,443,000                     | 3,524,000               |
| Loss on restaurant assets                             | 736,000                       | 564,000                 |
| Operating income                                      | 2,192,000                     | 2,696,000               |
| Interest expense:                                     |                               |                         |
| Bank debt and notes payable                           | 461,000                       | 647,000                 |
| Capital leases                                        | 1,406,000                     | 1,512,000               |
| Other (income) and expense, net                       | 438,000                       | (47,000 )               |
| Unrealized loss on derivatives                        | 130,000                       | -                       |
| Income (loss) before income taxes                     | (243,000 )                    | 584,000                 |
| Provision for income taxes                            | 234,000                       | 214,000                 |
| Net income (loss)                                     | \$ (477,000 )                 | \$ 370,000              |
| Basic net income (loss) per common share:             | \$ (0.12 )                    | \$ 0.13                 |
| Diluted net income (loss) per common share:           | \$ (0.12 )                    | \$ 0.13                 |
| Basic weighted average number of shares outstanding   | 3,875,374                     | 2,934,995               |
| Diluted weighted average number of shares outstanding | 3,875,374                     | 2,953,294               |

See notes to these consolidated financial statements.

## MORGAN'S FOODS, INC.

## CONSOLIDATED BALANCE SHEET

|                                                 | <b>November 10,<br/>2013<br/>(UNAUDITED)</b> | <b>March 3,<br/>2013</b> |
|-------------------------------------------------|----------------------------------------------|--------------------------|
| <b>ASSETS</b>                                   |                                              |                          |
| Current assets:                                 |                                              |                          |
| Cash and equivalents                            | \$ 2,676,000                                 | \$2,971,000              |
| Restricted cash                                 | 2,773,000                                    | 350,000                  |
| Receivables                                     | 459,000                                      | 609,000                  |
| Inventories                                     | 739,000                                      | 724,000                  |
| Prepaid expenses                                | 650,000                                      | 812,000                  |
| Assets held for sale                            | 1,120,000                                    | 583,000                  |
| Total current assets                            | 8,417,000                                    | 6,049,000                |
| Property and equipment:                         |                                              |                          |
| Land                                            | 350,000                                      | 1,075,000                |
| Buildings and improvements                      | 2,130,000                                    | 2,639,000                |
| Property under capital leases                   | 23,989,000                                   | 22,969,000               |
| Leasehold improvements                          | 12,463,000                                   | 12,308,000               |
| Equipment, furniture and fixtures               | 18,691,000                                   | 18,870,000               |
| Construction in progress                        | 420,000                                      | 26,000                   |
| Total property and equipment                    | 58,043,000                                   | 57,887,000               |
| Less accumulated depreciation and amortization  | 23,244,000                                   | 23,486,000               |
| Net book value of property and equipment        | 34,799,000                                   | 34,401,000               |
| Other assets                                    | 352,000                                      | 411,000                  |
| Franchise agreements, net                       | 591,000                                      | 689,000                  |
| Goodwill                                        | 8,896,000                                    | 8,950,000                |
| Total assets                                    | \$ 53,055,000                                | \$50,500,000             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>     |                                              |                          |
| Current liabilities:                            |                                              |                          |
| Long-term debt, current                         | \$ 942,000                                   | \$878,000                |
| Current maturities of capital lease obligations | 367,000                                      | 304,000                  |
| Accounts payable                                | 3,250,000                                    | 3,297,000                |
| Accrued liabilities                             | 3,749,000                                    | 3,800,000                |
| Total current liabilities                       | 8,308,000                                    | 8,279,000                |
| Long-term debt                                  | 7,789,000                                    | 7,338,000                |
| Long-term capital lease obligations             | 22,839,000                                   | 22,079,000               |
| Other long-term liabilities                     | 10,541,000                                   | 10,812,000               |
| Deferred tax liabilities                        | 3,367,000                                    | 3,175,000                |

SHAREHOLDERS' EQUITY (DEFICIT)

|                                                                      |               |                |
|----------------------------------------------------------------------|---------------|----------------|
| Preferred shares, 1,000,000 shares authorized, no shares outstanding | -             | -              |
| Common shares, no par value                                          |               |                |
| Authorized shares - 25,000,000                                       |               |                |
| Issued shares - 4,073,557 and 2,969,405                              | 41,000        | 30,000         |
| Treasury shares -25,410 and 34,410                                   | (60,000       | ) (81,000 )    |
| Capital in excess of stated value                                    | 31,327,000    | 29,488,000     |
| Accumulated deficit                                                  | (31,097,000   | ) (30,620,000) |
| Total shareholders' equity (deficit)                                 | 211,000       | (1,183,000 )   |
| Total liabilities & shareholders' equity (deficit)                   | \$ 53,055,000 | \$50,500,000   |

See notes to these consolidated financial statements

MORGAN'S FOODS, INC.  
CONSOLIDATED STATEMENT OF SHAREHOLDERS' EQUITY (DEFICIT)  
(UNAUDITED)

|                           |               |          |                 |            | Capital in   | Accumulated     | Total          |
|---------------------------|---------------|----------|-----------------|------------|--------------|-----------------|----------------|
|                           | Common Shares |          | Treasury Shares |            | Excess of    | Deficit         | Shareholders'  |
|                           | Shares        | Amount   | Shares          | Amount     | Stated Value |                 | Equity         |
|                           |               |          |                 |            |              |                 | (Deficit)      |
| Balance March 3, 2013     | 2,969,405     | \$30,000 | (34,410)        | \$(81,000) | \$29,488,000 | \$(30,620,000 ) | \$(1,183,000 ) |
| Exercise of share options | 21,333        | 200      | 9,000           | 21,000     | 24,000       | -               | 45,200         |
| Share grant compensation  | 30,569        | 300      | -               | -          | 107,000      | -               | 107,300        |
| Issuance of shares        | 1,052,250     | 10,500   | -               | -          | 1,708,000    | -               | 1,718,500      |
| Net loss                  | -             | -        | -               | -          | -            | (477,000 )      | (477,000 )     |
| Balance November 10, 2013 | 4,073,557     | \$41,000 | (25,410)        | \$(60,000) | \$31,327,000 | \$(31,097,000 ) | \$ 211,000     |

See notes to these consolidated financial statements.

## MORGAN'S FOODS, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

|                                                                        | <b>Thirty-six Weeks Ended</b> |                 |
|------------------------------------------------------------------------|-------------------------------|-----------------|
|                                                                        | <b>November</b>               | <b>November</b> |
|                                                                        | <b>10, 2013</b>               | <b>4, 2012</b>  |
| <b>Cash flows from operating activities:</b>                           |                               |                 |
| Net income (loss)                                                      | \$(477,000 )                  | \$370,000       |
| Adjustments to reconcile to net cash provided by operating activities: |                               |                 |
| Depreciation and amortization                                          | 2,071,000                     | 1,869,000       |
| Amortization of deferred financing costs                               | 333,000                       | 60,000          |
| Amortization of supply agreement advances                              | (648,000 )                    | (640,000 )      |
| Funding from supply agreements                                         | 770,000                       | 755,000         |
| Deferred income taxes                                                  | 192,000                       | 168,000         |
| Loss on restaurant assets                                              | 736,000                       | 564,000         |
| Change in fair value of derivatives                                    | 130,000                       | -               |
| Changes in assets and liabilities:                                     |                               |                 |
| Receivables                                                            | 120,000                       | (70,000 )       |
| Inventories                                                            | (15,000 )                     | (71,000 )       |
| Prepaid expenses                                                       | 162,000                       | (394,000 )      |
| Other assets                                                           | 18,000                        | 16,000          |
| Accounts payable                                                       | (149,000 )                    | (380,000 )      |
| Accrued liabilities                                                    | (343,000 )                    | (114,000 )      |
| Net cash, operating activities                                         | 2,900,000                     | 2,133,000       |
| <b>Cash flows from investing activities:</b>                           |                               |                 |
| Proceeds from sale of restaurants                                      | 131,000                       | 541,000         |
| Capital expenditures                                                   | (2,800,000)                   | (3,633,000)     |
| Restricted cash                                                        | (2,423,000)                   | 57,000          |
| Net cash, investing activities                                         | (5,092,000)                   | (3,035,000)     |
| <b>Cash flows from financing activities:</b>                           |                               |                 |
| Proceeds from long-term borrowings                                     | 8,930,000                     | -               |
| Additions to deferred financing costs                                  | (292,000 )                    | -               |
| Principal payments on long-term debt                                   | (647,000 )                    | (36,000 )       |
| Principal payments on capital lease obligations                        | (197,000 )                    | (63,000 )       |
| Bank debt repayment in advance                                         | (7,768,000)                   | -               |
| Cash from stock transactions                                           | 1,871,000                     | -               |
| Net cash, financing activities                                         | 1,897,000                     | (99,000 )       |
| Net change in cash and equivalents                                     | (295,000 )                    | (1,001,000)     |
| Cash and equivalents, beginning balance                                | 2,971,000                     | 3,455,000       |
| Cash and equivalents, ending balance                                   | \$2,676,000                   | \$2,454,000     |
| Interest paid on debt and capitalized leases                           | \$1,732,000                   | \$2,156,000     |

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|                                |          |          |
|--------------------------------|----------|----------|
| Cash payments for income taxes | \$61,000 | \$34,000 |
|--------------------------------|----------|----------|

See notes to these consolidated financial statements.

MORGAN'S FOODS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

**NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The interim consolidated financial statements of Morgan's Foods, Inc. (the "Company") have been prepared without audit. In the opinion of Company management, all adjustments have been included. Unless otherwise disclosed, all adjustments consist only of normal recurring adjustments necessary for a fair statement of results of operations for the interim periods. These unaudited financial statements have been prepared using the same accounting principles that were used in preparation of the Company's annual report on Form 10-K for the year ended March 3, 2013. Certain prior period amounts have been reclassified to conform to current period presentations. The results of operations for the thirty-six weeks ended November 10, 2013 are not necessarily indicative of the results to be expected for the full year. Although the Company believes that the disclosures are adequate to make the information presented not misleading, it is suggested that these condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company's Form 10-K for the fiscal year ended March 3, 2013.

The Company's bank debt is reported at historical cost and is almost entirely comprised of variable rate borrowings. The market for variable rate debt for restaurant financing is currently extremely limited. The Company's debt is not publicly traded and there are few lenders or financing transactions for similar debt in the marketplace at this time. Management has concluded that it is not practicable to estimate the fair value of the Company's debt as of November 10, 2013.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred losses in fiscal years 2013 and 2012 and has an accumulated deficit at November 10, 2013. The Company has managed its liquidity in fiscal 2013 and will manage its liquidity in fiscal 2014 through the refinancing of debt, the sale and leaseback of restaurant properties and the sale of additional equity. Should the Company have difficulty meeting its forecasts, this could have an adverse effect on its liquidity position. The Company has taken actions to improve its cash flows, including closely monitoring its expenses and store closings for underperforming stores and expects to be able to achieve its forecast for fiscal 2014. However, there can be no assurances that our cash flow will be sufficient to allow us to continue as a going concern if we are unable to meet our projections.

**NOTE 2 - RECENT ACCOUNTING PRONOUNCEMENTS**

ASU 2013-01 Balance Sheet Topic 210, January 2013

Clarifies the scope of disclosures related to offsetting assets and liabilities. This release reduces the application of these disclosures to eliminate unintended consequences resulting from the application of a previously issued standard. The standard is effective for fiscal years beginning on or after January 1, 2013. Management has determined that the application of this standard did not have a material effect on the financial statements of the Company.

ASU 2013-10 Derivatives and Hedging Topic 815, July 2013

Provides for the inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes, effective for swaps entered into after July 17, 2013. This release allows the use of the overnight index swap rate as an additional benchmark for hedge accounting treatment. Management has determined that the application of this standard will not have a material effect on the financial statements of the Company.

ASU 2013-11 Income Taxes Topic 740, July 2013

Provides for the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists, effective for fiscal years beginning after December 15, 2013. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if available and a company has the intent and ability to use for such purpose. Management has determined that the application of this standard will not have a material effect on the financial statements of the Company.

In September 2013, the Internal Revenue Service issued final regulations governing the income tax treatment of acquisitions, dispositions, and repairs of tangible property. Taxpayers are required to follow the new regulations in taxable years beginning on or after January 1, 2014. Management is currently assessing the impact of the regulations and does not expect they will have a material impact on the Company's financial statements.

### NOTE 3 – NET INCOME (LOSS) PER COMMON SHARE

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

|                                                | Quarter ended November 10, 2013 |               |              | Quarter ended November 4, 2012 |               |              |
|------------------------------------------------|---------------------------------|---------------|--------------|--------------------------------|---------------|--------------|
|                                                | Net<br>income                   | Shares        | Per<br>Share | Net<br>income                  | Shares        | Per<br>Share |
|                                                | (Numerator)                     | (Denominator) | Amount       | (Numerator)                    | (Denominator) | Amount       |
| <b>Basic EPS</b>                               |                                 |               |              |                                |               |              |
| Income (loss) available to common shareholders | \$(307,000)                     | 4,044,147     | \$ (0.08 )   | \$ 125,000                     | 2,934,995     | \$ 0.04      |
| <b>Effect of Dilutive Securities</b>           |                                 |               |              |                                |               |              |
| Weighted Average Stock Options                 | -                               | -             |              | -                              | 49,699        |              |
| <b>Diluted EPS</b>                             |                                 |               |              |                                |               |              |
| Income (loss) available to common shareholders | \$(307,000)                     | 4,044,147     | \$ (0.08 )   | \$ 125,000                     | 2,984,694     | \$ 0.04      |

|                                                | Thirty-six weeks ended November 10, 2013 |               |              | Thirty-six weeks ended November 4, 2012 |               |              |
|------------------------------------------------|------------------------------------------|---------------|--------------|-----------------------------------------|---------------|--------------|
|                                                | Net<br>income                            | Shares        | Per<br>Share | Net<br>income                           | Shares        | Per<br>Share |
|                                                | (Numerator)                              | (Denominator) | Amount       | (Numerator)                             | (Denominator) | Amount       |
| <b>Basic EPS</b>                               |                                          |               |              |                                         |               |              |
| Income (loss) available to common shareholders | \$(477,000)                              | 3,875,374     | \$ (0.12 )   | \$ 370,000                              | 2,934,995     | \$ 0.13      |
| <b>Effect of Dilutive Securities</b>           |                                          |               |              |                                         |               |              |
| Weighted Average Stock Options                 | -                                        | -             |              | -                                       | 18,299        |              |
| <b>Diluted EPS</b>                             |                                          |               |              |                                         |               |              |

|                                                |             |           |           |           |           |         |
|------------------------------------------------|-------------|-----------|-----------|-----------|-----------|---------|
| Income (loss) available to common shareholders | \$(477,000) | 3,875,374 | \$(0.12 ) | \$370,000 | 2,953,294 | \$ 0.13 |
|------------------------------------------------|-------------|-----------|-----------|-----------|-----------|---------|

Weighted average stock options of 67,139 shares for the quarter ended November 10, 2013 and 66,192 shares for the thirty-six weeks ended November 10, 2013 have been excluded from the calculations of diluted earnings per share because there was a net loss in those periods.

#### NOTE 4 – DEBT

On August 22, 2013 the Company entered into a new loan agreement, comprising two loan facilities, with Huntington National Bank, a national banking association (“Huntington”). The Loan Agreement contains two new loan facilities that, in addition to funding the cash remodel reserve, were used to pay off the Company’s outstanding loan balance of \$6,104,000, which carried an interest rate of 9.0%, the lender, Fortress Credit Corp. (“Fortress”), and a prepayment penalty of 1.0% of the balance. The two facilities under the Loan Agreement consist of a term loan and a time loan in the total amount of \$8,930,000. The refinance transaction resulted in the write-off of deferred financing costs of \$275,000 and prepayment penalties of \$61,000.

The Term Note consists of a \$7,930,000 three year term loan with an interest rate which has been fixed at the rate of 5.44% through the use of a derivative interest rate swap also entered into with Huntington. Principal and interest on the Term Note are payable in substantially equal monthly payments based on an eight year amortization with a balloon payment of the then remaining principal balance due and payable at the end of the three year term.

The Company's interest rate swap agreement (the "Swap") with Huntington National Bank had a notional amount at inception equal to the beginning balance of the Term Note, \$7,930,000, and amortizes according to the same schedule to hedge its exposure to the variable interest rate of the Term Note. The Company has not designated the Swap as an effective hedge, therefore unrealized changes in the fair value of the Swap will be shown in the Company's consolidated statements of operation as either income or expense and the fair value will be shown on the Company's consolidated balance sheet as an asset or liability, as applicable. The critical terms of the Swap are aligned with the terms of the Term Note, including maturity of August 10, 2016.

Under the Swap, the Company pays a fixed interest rate of 5.44% and it receives a variable interest rate equal to the 30 day London Interbank Offered Rate ("LIBOR") plus 4.25%. The Swap settles monthly on the same date as the payments are due on the Term Note. The difference between amounts to be received and paid under the Swap is recognized as a component of interest expense on the consolidated statements of operations. The Swap increased interest expense by \$17,000 for the quarter and year to date ended November 10, 2013. The market value of the Swap as of November 10, 2013 was a liability of \$130,000.

The Time Note consists of \$1,000,000 having an 18 month term, no scheduled principal payments and a floating interest rate at 30 day LIBOR plus 4.25%. Principal payments on the Time Note are expected to be made with the proceeds of the sales by the Company of excess real estate of closed restaurants. The balance, if any, at the end of the 18 month term will become due and payable. As of November 10, 2013, the Time Note had a balance of \$865,000.

During the fiscal third quarter, on October 12, 2013, the Company entered into a capitalized lease for a new KFC restaurant in Pennsylvania which replaced an older facility for which the Company owns the land and building. The term of the lease is 20 years and resulted in the recording of an asset and liability in the amount of \$1,020,000.

At November 10, 2013 the Company's term loan credit agreement requires the maintenance of a consolidated fixed charge coverage ratio ("FCCR") of 1.15 or greater regarding all of the Company's debt. The FCCR is calculated by dividing the cash flow before taxes, debt service and rent ("EBITDAR") for the previous 12 months by the debt service and capital expenditures less the cash remodel reserve payable for the same period. The Company's term loan also requires a consolidated cash adjusted leverage ratio ("Leverage") of not greater than 5.25. Leverage is calculated by dividing the sum of debt and 8 times lease payments less cash, including the remodel reserve, by EBITDAR. The ratios are computed quarterly. At the end of the third quarter of fiscal 2014, the Company had a FCCR of 1.31 and a Leverage ratio of 5.07, being in compliance with all of the required ratios.

#### **NOTE 5 - STOCK OPTIONS AND LTIP UNITS**

On April 2, 1999, the Board of Directors of the Company approved a Stock Option Plan for Executives and Managers. Under the plan 145,500 shares were reserved for the grant of options. The Stock Option Plan for Executives and Managers provides for grants to eligible participants of nonqualified stock options only. The exercise price for any option awarded under the Plan is required to be not less than 100% of the fair market value of the shares on the date that the option is granted. Options are granted by the Stock Option Committee of the Company. Options for 145,150 shares were granted to executives and managers of the Company on April 2, 1999 at an exercise price of \$4.125, all of which have either expired or been exercised. Options for 350 common shares were granted on November 6, 2008 at the closing price on that day of \$1.50 per share all of which are currently outstanding. The options vested in six months and expire ten years after date of issue.

At the Company's annual meeting on June 25, 1999 the shareholders approved the Key Employees Stock Option Plan. This plan allows the granting of options covering 291,000 common shares and has essentially the same provisions as the Stock Option Plan for Executives and Managers which was discussed above. Options for 129,850 shares were granted to executives and managers of the Company on January 7, 2000 at an exercise price of \$3.00. Options for 11,500 shares were granted to executives on April 27, 2001 at an exercise price of \$.85, all of which have either expired or been exercised. Options for 149,650 common shares were granted on November 6, 2008 at the closing price on that day of \$1.50 per share of which 114,317 are currently outstanding. The options vested in six months and expire ten years after date of issue.

As of November 10, 2013, a total of 114,667 options were outstanding, fully vested and exercisable at a weighted average exercise price of \$1.50 per share. Options for 8,000 shares were exercised during the third quarter of fiscal 2014. No options are available for grant and no options were granted during the current year period. The Company recorded no compensation expense during the current year period related to stock options.

The following table summarizes information about stock options outstanding at November 10, 2013:

| <b>Exercise</b> | <b>Outstanding</b> | <b>Average</b> | <b>Number</b>      |
|-----------------|--------------------|----------------|--------------------|
| <b>Prices</b>   | <b>11-10-13</b>    | <b>Life</b>    | <b>Exercisable</b> |
| 1.50            | 114,667            | 4.9            | 114,667            |

On April 9, 2013, the Board of Directors approved a Long-Term Incentive Plan, (“LTIP”) reserving 150,000 common shares of the Company for issuance under the LTIP. On April 9, 2013, 30,569 restricted common shares were granted under the LTIP to outside directors of the Company, leaving 119,431 shares available for future grant under the LTIP. The shares issued under the LTIP vest in six months and compensation expense related to such shares totaled \$36,000 for the third quarter and \$107,000 for the full year which completes the compensation expense for the grants. Additional information regarding the LTIP may be found in a report on Form 8-K filed with the SEC on April 15, 2013.

#### **NOTE 6 – CAPITAL EXPENDITURES**

The Company is required by its franchise agreements to periodically bring its restaurants up to the required image of the franchisor. This typically involves a new dining room décor and seating package and exterior changes and related items but can, in some cases, require the relocation of the restaurant. If the Company deems a particular image enhancement expenditure to be inadvisable, it has the option to cease operations at that restaurant. Over time, the estimated cost and time deadline for each restaurant may change due to a variety of circumstances and the Company revises its requirements accordingly. Also, significant numbers of restaurants may have image enhancement deadlines that coincide, in which case, the Company will adjust the actual timing of the image enhancements in order to facilitate an orderly construction schedule. During the image enhancement process, each restaurant is normally closed for up to two weeks, which has a negative impact on the Company’s revenues and operating efficiencies. At the time a restaurant is closed for a required image enhancement, the Company may deem it advisable to make other capital expenditures in addition to those required for the image enhancement.

The franchise agreements with KFC and Taco Bell Corporation require the Company to upgrade and remodel its restaurants to comply with the franchisors’ current standards within agreed upon timeframes and the franchisor may terminate the franchise agreement for failure to meet those requirements. In the case of a restaurant containing two concepts, even though only one is required to be remodeled, additional costs will be incurred because the dual concept restaurant is generally larger and contains more equipment and signage than the single concept restaurant. If a property is of usable size and configuration, the Company can perform an image enhancement to bring the building to the current image of the franchisor. If the property has a deficiency which would render it unsuitable, the Company would need to relocate the restaurant to another location within the trade area to meet the franchisor’s requirements. The capital requirements for the KFC branded restaurants are included in the schedule based on the requirements of the KFC Remodel Agreement as amended and the Taco Bell restaurants are shown at the time required by the Taco

Bell remodel program implemented during the fiscal 2014 third quarter.

| <b>Number<br/>of Units</b> | <b>Period</b>         | <b>Type</b>    | <b>Capital<br/>Cost (1)</b> |
|----------------------------|-----------------------|----------------|-----------------------------|
| 4                          | Fiscal<br>2015        | Remodels       | <b>900,000</b>              |
| 7                          | Fiscal<br>2016        | Remodels       | <b>1,655,000</b>            |
| 4                          | Fiscal<br>2017        | Remodels       | 1,000,000                   |
| 1                          | Fiscal<br>2017        | Refresh<br>(2) | 100,000                     |
| 1                          | Fiscal<br>2017        | Taco Bell      | 350,000                     |
|                            | <b>Total<br/>2017</b> |                | <b>1,450,000</b>            |
| 3                          | Fiscal<br>2018        | Remodels       | 790,000                     |
| 1                          | Fiscal<br>2018        | Refresh<br>(2) | 100,000                     |
| 1                          | Fiscal<br>2018        | Taco Bell      | 350,000                     |
|                            | <b>Total<br/>2018</b> |                | <b>1,240,000</b>            |
| 4                          | Fiscal<br>2019        | Remodels       | 940,000                     |
| 1                          | Fiscal<br>2019        | Taco Bell      | 350,000                     |
|                            | <b>Total<br/>2019</b> |                | <b>1,290,000</b>            |
| 7                          | Fiscal<br>2020        | Refresh<br>(2) | <b>675,000</b>              |
| 7                          | Fiscal<br>2021        | Refresh<br>(2) | <b>675,000</b>              |
| 7                          | Fiscal<br>2022        | Refresh<br>(2) | 650,000                     |
| 1                          | Fiscal<br>2022        | Taco Bell      | 350,000                     |
|                            | <b>Total<br/>2022</b> |                | <b>1,000,000</b>            |
| 8                          | Fiscal<br>2023        | Refresh<br>(2) | 725,000                     |
| 1                          | Fiscal<br>2023        | Taco Bell      | 350,000                     |
|                            | <b>Total<br/>2023</b> |                | <b>1,075,000</b>            |
| 1                          | Fiscal<br>2024        | Taco Bell      | <b>350,000</b>              |

|           |                |                |                     |
|-----------|----------------|----------------|---------------------|
| 1         | Fiscal<br>2025 | Refresh<br>(2) | 75,000              |
| 1         | Fiscal<br>2025 | Taco Bell      | 350,000             |
|           | <b>Total</b>   |                | <b>425,000</b>      |
| <b>61</b> | <b>Total</b>   |                | <b>\$10,735,000</b> |

(1) These amounts are based on estimates of current construction costs and actual costs may vary.

(2) Reflects the estimated cost of dining room update and exterior paint and refurbishment on restaurants previously remodeled to the current image. Costs may also include the addition of equipment such as coolers necessary to meet Franchisor standards.

In addition to the various facilities actions listed on the table above, the Company is obligated to spend an additional amount of approximately \$1,000,000 by the end of calendar year 2014 to install the KFC operations platform consisting of a new point of sale system and related reporting and management systems, new food holding cabinets that improve the quality of product held for sale and a new drive-thru speed of service system in all of its KFC and KFC/Taco Bell "2n1" restaurants. The Company has spent approximately \$1,425,000 to date on the operations platform and POS devices for its KFC and Taco Bell restaurants. During the third quarter, the Company completed the relocation of one of its restaurants in Pennsylvania. The new restaurant is a leased facility and the Company owns the land and building of the former location which is under contract to be sold but the transaction had not closed as of the date of this report.

Capital expenditures to meet the image requirements of the franchisors and additional capital expenditures on those same restaurants being image enhanced are a large portion of the Company's annual capital expenditures. However, the Company also has made and may make capital expenditures on restaurant properties not included on the foregoing schedule for upgrades or replacement of capital items appropriate for the continued successful operation of its restaurants. The Company may not be able to finance capital expenditures in the volume and time horizon required by the image enhancement deadlines solely from existing cash balances and existing cash flow and the Company may have to utilize financing for a portion of the capital expenditures. The Company may use debt and build to suit or sale/leaseback financing but has no commitments for any financing at this time.

There can be no assurance that the Company will be able to accomplish the image enhancements and relocations required in the franchise agreements on terms acceptable to the Company. If the Company is unable to meet the requirements of a franchise agreement, the franchisor may choose to extend the time allowed for compliance or may terminate the franchise agreement for the affected location.

#### **NOTE 7 – ASSET ACTIVITIES**

The Company owns the land and building of six closed KFC restaurants, all of which are listed for sale and are shown on the Company's consolidated balance sheet as Assets Held for Sale as of November 10, 2013. Three of the restaurants were closed during the Company's fiscal third quarter, one of which was due to relocation of the restaurant operation. Additionally, the Company closed a KFC restaurant in Ohio during the third quarter and sold the land and building.

The Company experienced a loss on restaurant assets of \$205,000 for the third quarter of fiscal 2014 consisting of \$30,000 related to recording the reserve for disposal of two permanently closed restaurant locations, \$36,000 of closed unit expenses, a charge to goodwill related to the sale of one property of \$53,000 and \$86,000 of other asset disposals.

The loss on restaurant assets of \$736,000 for the thirty-six weeks ended November 10, 2013 consisted of \$102,000 related to closed unit expense, \$66,000 change in reserve for the disposal of two permanently closed leased restaurant locations, \$149,000 in write downs of sold restaurants, \$166,000 related to the disposal of certain restaurant assets, a charge to goodwill related to the sale of one property of \$53,000 and a \$200,000 reduction in the value of assets held for sale of two closed locations.

#### **NOTE 8 – CONTINGENCIES**

The Company is a party to various legal proceedings and claims arising in the ordinary course of its business. The Company believes that the outcome of these matters will not have a material adverse effect on its consolidated financial position, results of operations or liquidity.

## **NOTE 9 - EQUITY TRANSACTION**

On April 12, 2013, the Company issued, in a transaction exempt from registration under the Securities Act of 1933, 1,052,250 common shares to Bandera Master Fund LP at a price of \$2.00 per share, resulting in net proceeds of \$1,718,500 after considering transaction costs of \$386,000. The transaction was negotiated and approved by a Special Committee of the Board of Directors. The terms of the Company's credit agreement required that the net proceeds of the equity transaction be paid as a principal payment in addition to regularly scheduled payments on the credit facility. The transaction is included in the financial statements of the Company and more fully described in a report on Form 8-K filed with the SEC on April 15, 2013.

## **NOTE 10 – SUBSEQUENT EVENTS**

On November 24, 2013, subsequent to the balance sheet date, the Company closed a restaurant in St. Louis, MO for which it owns the land and building and has it listed for sale. On December 18, 2013, subsequent to the balance sheet date, the Company completed the sale of a closed restaurant location in Ballwin, MO for net proceeds of \$224,000 and resulting in a write off of goodwill in the amount of \$104,000.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Description of Business. Morgan's Foods, Inc. (the "Company"), which was formed in 1925, operates through wholly-owned subsidiaries KFC restaurants under franchises from KFC Corporation, Taco Bell restaurants under franchises from Taco Bell Corporation, and Pizza Hut Express restaurants under licenses from Pizza Hut Corporation. As of December 18, 2013, the Company operates 53 KFC restaurants, four Taco Bell restaurants, nine KFC/Taco Bell "2n1's" under franchises from KFC Corporation and franchises from Taco Bell Corporation and three Taco Bell/Pizza Hut Express "2n1's" under franchises from Taco Bell Corporation and licenses from Pizza Hut Corporation. The Company's fiscal year is a 52 - 53 week year ending on the Sunday nearest the last day of February.

**Summary of Expenses and Operating Income as a Percentage of Revenues**

|                                     | Twelve Weeks<br>Ended<br>November<br>10, 2013 |      |   | Thirty-six Weeks<br>Ended<br>November<br>10, 2013 |      |   |
|-------------------------------------|-----------------------------------------------|------|---|---------------------------------------------------|------|---|
|                                     | November<br>4, 2012                           |      |   | November<br>4, 2012                               |      |   |
| Cost of sales:                      |                                               |      |   |                                                   |      |   |
| Food, paper and beverage            | 32.2 %                                        | 32.2 | % | 32.6 %                                            | 32.4 | % |
| Labor and benefits                  | 28.6 %                                        | 28.6 | % | 28.5 %                                            | 28.3 | % |
| Restaurant operating expenses       | 24.3 %                                        | 25.3 | % | 24.7 %                                            | 25.1 | % |
| Depreciation and amortization       | 3.7 %                                         | 3.2  | % | 3.5 %                                             | 3.1  | % |
| General and administrative expenses | 5.6 %                                         | 5.7  | % | 5.8 %                                             | 5.8  | % |
| Operating income                    | 4.5 %                                         | 4.4  | % | 3.7 %                                             | 4.4  | % |

**Revenues** The revenue decrease of \$1,010,000 in the quarter ended November 10, 2013 as compared to the prior year quarter was primarily the result of a 3.0%, or \$585,000, comparable sales decrease, \$511,000 from the permanent closing of a Taco Bell restaurant and three KFC restaurants, partially offset by additional sales of \$64,000 for restaurants that were temporarily closed for remodeling in the prior year quarter. The comparable sales decrease was primarily the result of poor sales performance in the KFC concept resulting in a comparable sales decrease of 4.3% for KFC sales only.

The revenue decrease of \$1,284,000 for the thirty-six weeks ended November 10, 2013 as compared to the prior year period was the result of a 0.1%, or \$37,000, decrease in comparable restaurant revenue, reflecting comparable increases in the first quarter offset by the KFC sales declines in the second and third quarters, additional sales of \$268,000 from the temporary closing of eight restaurants for remodeling during the prior year period, offset by \$1,314,000 from the permanent closing of three restaurant locations and \$202,000 from the temporary closing of five restaurants for rebuilding or repairs during the current year period.

**Cost of Sales - Food, Paper and Beverage** Food, paper and beverage costs remained the same as a percentage of revenue at 32.2% for both the current year and prior year quarters. Food, paper and beverage costs for the thirty-six weeks ended November 10, 2013 increased slightly to 32.6% compared to 32.4% in the comparable prior year period.

**Cost of Sales - Labor and Benefits** Labor and benefits remained the same as a percentage of revenue at 28.6% for both the current year and prior year quarters. Labor and benefits increased slightly to 28.5% of revenue for the thirty-six weeks ended November 10, 2013 compared to 28.3% of revenue in the comparable prior year period.

Restaurant Operating Expenses Restaurant operating expenses decreased to 24.3% of revenue in the third quarter of fiscal 2014 compared to 25.3% of revenue in the third quarter of fiscal 2013 primarily due to decreased expenses for manager bonuses, advertising, repairs and maintenance and utilities. For the thirty-six weeks ended November 10, 2013, restaurant operating expenses decreased to 24.7% of revenue from 25.1% of revenue in the prior year period primarily due to reduced utilities, manager bonuses and advertising expense.

Depreciation and Amortization Depreciation and amortization of \$707,000 for the quarter ended November 10, 2013 increased from \$644,000 in the prior year quarter. This increase was a result of an increased balance of tangible assets. Depreciation and amortization of \$2,071,000 for the thirty-six weeks ended November 10, 2013 increased from \$1,869,000 in the prior year period due to an increased balance of tangible assets.

General and Administrative Expenses General and administrative expenses decreased to \$1,068,000 in the third quarter of fiscal 2014 compared to \$1,140,000 in the third quarter of fiscal 2014. This decrease was the result of reduction in executive staff and related benefits, partially offset by increased director fees related to restricted share grants to outside directors. General and administrative expense decreased slightly to \$3,443,000 in the thirty-six weeks ended November 10, 2013 compared to \$3,524,000 in the thirty-six weeks ended November 4, 2012 due to the reduction in executive staff and related benefits, and external accounting services, partially offset by the increase related to restricted share grants to outside directors.

Loss on Restaurant Assets The Company experienced a loss on restaurant assets of \$205,000 for the third quarter of fiscal 2014 compared to a loss of \$106,000 in the comparable prior year quarter. The current fiscal year loss consisted of \$30,000 related to recording the reserve for disposal of two permanently closed restaurant locations, \$36,000 of closed unit expenses, a charge to goodwill related to the sale of one property of \$53,000 and \$86,000 of other asset disposals. The prior year included \$76,000 related to recording the reserve for disposal of two permanently closed restaurant locations, \$16,000 of closed unit expense, and \$14,000 of other asset disposal.

The Company experienced a loss on restaurant assets of \$736,000 for the thirty-six weeks ended November 10, 2013 compared to a loss of \$564,000 for the thirty-six weeks ended November 4, 2012. The current fiscal year loss consisted of \$102,000 related to closed unit expense, \$66,000 change in reserve for the disposal of two permanently closed leased restaurant locations, \$149,000 in write downs of sold restaurants, \$166,000 related to the disposal of certain restaurant assets, a charge to goodwill related to the sale of one property of \$53,000 and a \$200,000 reduction in the value of assets held for sale of two closed locations. The fiscal 2013 loss consisted of \$56,000 related to closed unit expense, \$223,000 change in reserve for the disposal of two permanently closed leased restaurant locations, \$26,000 related to the disposal of certain restaurant locations, a charge to goodwill related to the sale of three properties of \$123,000, and a \$136,000 reduction in the value of assets held for sale of two closed locations and the sale of four closed locations.

Operating Income Operating income decreased slightly to \$850,000, or 4.5% of revenue, for the quarter ended November 10, 2013 from \$884,000, or 4.4% of revenue, in the prior year quarter. The decrease of \$34,000 was the result of the items discussed above. Operating income for the thirty-six weeks ended November 10, 2013 decreased to \$2,192,000, or 3.7% of revenue, compared to \$2,696,000, or 4.4% of revenue, in the prior year period. The decrease of \$479,000 was the result of the items discussed above.

Interest Expense Interest expense on bank debt and notes payable decreased to \$127,000 in the third quarter of fiscal 2014 from \$200,000 in fiscal 2013 due to lower interest rates on new debt balances. Interest expense from capitalized lease debt decreased to \$465,000 in the third quarter of fiscal 2014 from \$504,000 in fiscal 2013 due to lower capital lease balances.

Interest expense on bank debt and notes payable decreased to \$461,000 in the thirty-six weeks ended November 10, 2013 from \$647,000 in the thirty-six weeks ended November 4, 2012 due to lower interest rates on new debt balances. Interest expense from capitalized lease debt decreased to \$1,406,000 in the thirty-six weeks ended November 10, 2013 from \$1,512,000 in the thirty-six weeks ended November 4, 2012 due to lower capital lease balances.

Other Income and Expense Other income and expense was an expense of \$372,000 for the third quarter and an expense of \$438,000 for the first thirty-six weeks of fiscal 2014 compared to income of \$16,000 for the third quarter and income of \$47,000 for the first thirty-six weeks of fiscal 2013. The thirty-six weeks of fiscal 2014 expense was primarily the result of fees related to the early termination of a Taco Bell franchise agreement and the write off of

deferred financing expenses related to the refinancing of the Company's debt on August 22, 2013.

Unrealized Loss on Derivatives The loss of \$130,000 reflects the change in the fair value of an interest rate swap entered into on August 23, 2013 to offset the changes in interest on the Company's variable rate bank debt and has no effect on the Company's cash flow. The swap has a maturity of August 10, 2016 and at that date will have a zero value. If the Company holds the interest rate swap to maturity, as planned, the net effect of the gains and losses over the term will be zero.

Provision for Income Taxes The provision for income taxes for the quarter ended November 10, 2013 was \$63,000 on a pre-tax loss of \$244,000 compared to \$71,000 on pre-tax income of \$196,000 for the comparable prior year period. The provision consists of a current tax provision of \$10,000 and a deferred tax provision of \$53,000 compared to a current tax provision of \$15,000 and a deferred tax provision of \$56,000 for the comparable prior year period.

The provision for income taxes for the thirty-six weeks ended November 10, 2013 was \$234,000 on a pre-tax loss of \$243,000 compared to \$214,000 on pre-tax income of \$584,000 for the comparable prior year period. The components of the tax provision for the thirty-six weeks ended November 10, 2013 were a current tax provision of \$42,000 and a deferred tax provision of \$192,000 compared to a current tax provision of \$46,000 and a deferred tax provision of \$168,000 for the comparable prior year period. The deferred tax provision for the quarter, thirty-six weeks and comparable prior year periods are a result of deferred tax liabilities associated with franchise rights and goodwill that cannot be used in determining net deferred tax assets. The Company continues to fully reserve its net deferred tax assets to zero.

Additionally, the Company has determined that the use of its annual effective tax rate would not be appropriate to record its income taxes because a small change in its estimate of income would result in a large change in its effective tax rate. Accordingly, the Company recorded its income taxes based on its results for the quarter and the thirty-six weeks ended November 10, 2013 and for the comparable prior year periods.

**Liquidity and Capital Resources** Cash provided by operating activities was \$2,900,000 for the thirty-six weeks ended November 10, 2013 compared to \$2,133,000 for the thirty-six weeks ended November 4, 2012. Primary factors causing the change were:

a net loss of \$477,000 in the current year period compared to a net income of \$370,000 in the prior year period;  
 \$202,000 more in depreciation and amortization in the current fiscal year compared to the prior fiscal year;  
 increase of \$172,000 in loss on restaurant assets in the current year;  
 \$130,000 of unrealized loss on the change in fair value of derivatives in the current year;  
 reduction of \$162,000 in prepaid expenses in the current year compared to an increase of \$394,000 in the prior year;  
 \$273,000 more in amortization of deferred financing costs in the current fiscal year compared to the prior fiscal year;  
 reduction of \$120,000 in receivables in the current year compared to an increase of \$70,000 in the prior year; and  
 \$56,000 less of increase in inventories in the current year compared to the prior year.

The change in prepaid expenses was due primarily to the relationship of the balance sheet date to the first of the month, affecting prepaid rent and other similar items. The loss on restaurant assets reflects the decrease in carrying value of certain assets held for sale and impairment of the value of a restaurant to be sold. The increase in amortization of deferred financing costs reflects the write off related to the refinancing of the Company's debt. The decrease in receivables in the current fiscal year was primarily the result of the receipt of beverage vendor rebates during the year. Cash used in investing activities for the current fiscal year of \$5,092,000 is the product of remodel capital expenditures and the establishment of the \$2,500,000 cash remodel reserve required by the bank financing arrangement. In the prior year, the \$3,035,000 of cash used by investing activities consisted primarily of \$3,633,000 of cash used in the image enhancement of facilities, and installation of the KFC operations platform, offset by the proceeds from the sale of restaurant locations. The Company made principal payments of \$647,000 and payments in advance of scheduled maturities of \$7,768,000, received \$8,930,000 of proceeds from new borrowings offset by \$292,000 of additions to deferred financing costs and received cash from equity transactions of \$1,871,000 in the current fiscal year, compared to scheduled principal payments of \$36,000 in the comparable prior year quarter. Management believes that its operating cash flows and available cash for the coming year will be sufficient to meet its liquidity and capital resource needs.

On April 12, 2013, the Company issued, in a transaction exempt from registration under the Securities Act of 1933, 1,052,250 common shares to Bandera Master Fund LP at a price of \$2.00 per share, resulting in net proceeds of \$1,718,500 after considering transaction costs of \$386,000. The transaction was negotiated and approved by the Special Committee of the Board of Directors. The terms of the Company's credit agreement required that the net proceeds of the equity transaction be paid as a principal payment in addition to regularly scheduled payments on the credit facility. The transaction is included in the financial statements of the Company and more fully described in a report on Form 8-K filed with the SEC on April 15, 2013.

On August 22, 2013 the Company entered into a new loan agreement, comprising two loan facilities, with Huntington National Bank, a national banking association ("Huntington"). The Loan Agreement contains two new loan facilities that, in addition to funding the cash remodel reserve, were used to pay off the Company's outstanding loan balance of \$6,104,000, which carried an interest rate of 9.0%, the lender, Fortress Credit Corp. ("Fortress"), and a prepayment penalty of 1.0% of the balance. The two facilities under the Loan Agreement consist of a term loan and a time loan in the total amount of \$8,930,000. The refinance transaction resulted in the write-off of deferred financing costs of \$275,000 and prepayment penalties of \$61,000.

The Term Note consists of a \$7,930,000 three year term loan with an interest rate which has been fixed at the rate of 5.44% through the use of a derivative interest rate swap also entered into with Huntington. Principal and interest on the Term Note are payable in substantially equal monthly payments based on an eight year amortization with a balloon payment of the then remaining principal balance due and payable at the end of the three year term.

The Company's interest rate swap agreement (the "Swap") with Huntington National Bank had a notional amount at inception equal to the beginning balance of the Term Note, \$7,930,000, and amortizes according to the same schedule to hedge its exposure to the variable interest rate of the Term Note. The Company has not designated the Swap as an effective hedge, therefore unrealized changes in the fair value of the Swap will be shown in the Company's consolidated statements of operation as either income or expense and the fair value will be shown on the Company's consolidated balance sheet as an asset or liability, as applicable. The critical terms of the Swap are aligned with the terms of the Term Note, including maturity of August 10, 2016.

Under the Swap, the Company pays a fixed interest rate of 5.44% and it receives a variable interest rate equal to the 30 day London Interbank Offered Rate ("LIBOR") plus 4.25%. The Swap settles monthly on the same date as the payments are due on the Term Note. The difference between amounts to be received and paid under the Swap is recognized as a component of interest expense on the consolidated statements of operations. The Swap increased interest expense by \$17,000 for the quarter and year to date ended November 10, 2013. The market value of the Swap as of November 10, 2013 was a liability of \$130,000.

The Time Note consists of \$1,000,000 having an 18 month term, no scheduled principal payments and a floating interest rate at 30 day LIBOR plus 4.25%. Principal payments on the Time Note are expected to be made with the proceeds of the sales by the Company of excess real estate of closed restaurants. The balance, if any, at the end of the 18 month term will become due and payable. As of November 10, 2013, the Time Note had a balance of \$865,000.

During the fiscal third quarter, on October 12, 2013, the Company entered into a capitalized lease for a new KFC restaurant in Pennsylvania which replaced an older facility for which the Company owns the land and building. The term of the lease is 20 years and resulted in the recording of an asset and liability in the amount of \$1,020,000.

At November 10, 2013 the Company's term loan credit agreement requires the maintenance of a consolidated fixed charge coverage ratio ("FCCR") of 1.15 or greater regarding all of the Company's debt. The FCCR is calculated by dividing the cash flow before taxes, debt service and rent ("EBITDAR") for the previous 12 months by the debt service and capital expenditures less the cash remodel reserve payable for the same period. The Company's term loan also requires a consolidated cash adjusted leverage ratio ("Leverage") of not greater than 5.25. Leverage is calculated by dividing the sum of debt and 8 times lease payments less cash, including the remodel reserve, by EBITDAR. The ratios are computed quarterly. At the end of the third quarter of fiscal 2014, the Company had a FCCR of 1.31 and a Leverage ratio of 5.07, being in compliance with all of the required ratios.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company has incurred losses in fiscal years 2013 and 2012 and has an accumulated deficit at November 10, 2013. The Company has managed its liquidity in fiscal 2013 and will manage its liquidity in fiscal 2014 through the refinancing of debt, the sale and leaseback of restaurant properties and the sale of additional equity. Should the Company have difficulty meeting its forecasts, this could have an adverse effect on its liquidity position. The Company has taken actions to improve its cash flows, including closely monitoring its expenses and store closings for underperforming stores and expects to be able to achieve its forecast for fiscal 2014. However, there can be no assurances that our cash flow will be sufficient to allow us to continue as a going concern if we are unable to meet our projections.

#### Recent Accounting Pronouncements

##### ASU 2013-01 Balance Sheet Topic 210, January 2013

Clarifies the scope of disclosures related to offsetting assets and liabilities. This release reduces the application of these disclosures to eliminate unintended consequences resulting from the application of a previously issued standard. The standard is effective for fiscal years beginning on or after January 1, 2013. Management has determined that the application of this standard did not have a material effect on the financial statements of the Company.

ASU 2013-10 Derivatives and Hedging Topic 815, July 2013

Provides for the inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes, effective for swaps entered into after July 17, 2013. This release allows the use of the overnight index swap rate as an additional benchmark for hedge accounting treatment. Management has determined that the application of this standard will not have a material effect on the financial statements of the Company.

ASU 2013-11 Income Taxes Topic 740, July 2013

Provides for the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists, effective for fiscal years beginning after December 15, 2013. An unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward if available and a company has the intent and ability to use for such purpose. Management has determined that the application of this standard will not have a material effect on the financial statements of the Company.

In September 2013, the Internal Revenue Service issued final regulations governing the income tax treatment of acquisitions, dispositions, and repairs of tangible property. Taxpayers are required to follow the new regulations in taxable years beginning on or after January 1, 2014. Management is currently assessing the impact of the regulations and does not expect they will have a material impact on the Company's financial statements.

Seasonality The operations of the Company are affected by seasonal fluctuations. Historically, the Company's revenues and income have been highest during the summer months with the fourth fiscal quarter representing the slowest period. This seasonality is primarily attributable to weather conditions in the Company's marketplace, which consists of portions of Ohio, Pennsylvania, Missouri, Illinois, West Virginia and New York.

Safe Harbor Statements This quarterly report on Form 10-Q contains "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The statements include those identified by such words as "may," "will," "expect" "anticipate," "believe," "plan" and other similar terminology. Forward looking statements involve risks and uncertainties that could cause actual events or results to differ materially from those expressed or implied in this report. The forward-looking statements reflect the Company's current expectations and are based upon data available at the time of the statements. Actual results involve risks and uncertainties, including both those specific to the Company and general economic and industry factors. Factors specific to the Company include, but are not limited to, its debt covenant compliance, actions that lenders may take with respect to any debt covenant violations, its ability to obtain waivers of any debt covenant violations and its ability to pay all of its current and long-term obligations and those factors described in Part I Item 1A ("Risk Factors") of the Company's Annual Report on Form 10-K filed with the SEC on June 3, 2013. Economic and industry risks and uncertainties include, but are not limited, to, franchisor promotions, business and economic conditions, legislation and governmental regulation, competition, success of operating initiatives and advertising and

promotional efforts, volatility of commodity costs and increases in minimum wage and other operating costs, availability and cost of land and construction, consumer preferences, spending patterns and demographic trends. In addition, the forward-looking statements contained herein represent our estimates only as of the date of this filing and should not be relied upon as representing our estimates as of any subsequent date. While we may elect to update these forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, whether to reflect actual results, changes in assumptions, changes in other factors affecting such forward-looking statements or otherwise.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The majority of the Company's debt, approximately \$7.8 million of principal balance has its interest rate fixed by the use of an interest rate swap. The remaining \$865,000 has a variable rate which is adjusted monthly. A one percent increase in the variable rate base (90 day LIBOR) of the loan at the beginning of the year would increase the Company's annual interest costs by approximately \$9,000 for the year. The Company does not enter into derivative financial investments for trading or speculation purposes. Also, the Company is subject to volatility in food costs as a result of market risk and we manage that risk through the use of a franchisee purchasing cooperative which uses longer term purchasing contracts. Our ability to recover increased costs through higher pricing is, at times, limited by the competitive environment in which we operate. The Company believes that its market risk exposure is not material to the Company's financial position, liquidity or results of operations.

#### **Item 4. Controls and Procedures.**

##### **Evaluation of Disclosure Controls and Procedures**

The Principal Executive Officer (“PEO”) and Principal Financial Officer (“PFO”) carried out an evaluation of the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (“the Exchange Act”)) as of the end of the quarter ended November 10, 2013. Based on that evaluation, the Company’s PEO and PFO concluded that our disclosure controls and procedures were effective as of November 10, 2013.

##### **Changes in Internal Control Over Financial Reporting**

There were no changes in the Company’s internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter ended November 10, 2013 that materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

## **PART II – OTHER INFORMATION**

#### **Item 1. Legal Proceedings**

The Company is a party to various legal proceedings and claims arising in the ordinary course of its business. The Company believes that the outcome of these matters will not have a material adverse affect on its consolidated financial position, results of operations or liquidity.

#### **Item 1A. Risk Factors**

The Company’s Annual Report on Form 10-K for the fiscal year ended March 3, 2013 discusses the risk factors facing the Company. There has been no material change in the risk factors facing our business since March 3, 2013.

**Item 2. Unregistered Sale of Equity Securities and Use of Proceeds**

None

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosure**

Not applicable

**Item 5. Other Information**

None

**Item 6. Exhibits**

Reference is made to “Index to Exhibits”

SIGNATURES

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

MORGAN'S FOODS, INC.

/s/ Kenneth L. Hignett  
Kenneth L. Hignett  
Executive Vice President,  
Chief Financial Officer and Secretary  
December 20, 2013

## INDEX TO EXHIBITS

| Exhibit       | <u>Exhibit Description</u>                                                                                                                                                                                             |
|---------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <u>Number</u> |                                                                                                                                                                                                                        |
| 10.1          | Third Amendment dated October 22, 2013 to the Remodel Agreement, dated December 9, 2011 between the Company and KFC Corporation                                                                                        |
| 10.2          | Credit Agreement dated August 23, 2103 between the Company and Huntington National Bank                                                                                                                                |
| 31.1          | Certification of the President and Interim Chief Executive Officer pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                 |
| 31.2          | Certification of the Executive Vice President, Chief Financial Officer & Secretary pursuant to Rule 13a-14(a) of Securities Exchange Act of 1934, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1          | Certification of the President and Interim Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                           |
| 32.2          | Certification of the Executive Vice President, Chief Financial Officer and Secretary pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                         |
| 101.INS       | XBRL Instance                                                                                                                                                                                                          |
| 101.SCH       | XBRL Taxonomy Extension Schema                                                                                                                                                                                         |
| 101.CAL       | XBRL Taxonomy Extension Calculation                                                                                                                                                                                    |
| 101.DEF       | XBRL Taxonomy Extension Definition                                                                                                                                                                                     |
| 101.LAB       | XBRL Taxonomy Extension Labels                                                                                                                                                                                         |
| 101.PRE       | XBRL Taxonomy Extension Presentation                                                                                                                                                                                   |