MEXICAN RESTAURANTS INC
Form 10-Q
May 18, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended April 4, 2010

OR

o 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	76-0493269
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)
12000 Aerospace Ave., Suite 400, Houston, Texas	77034
(Address of Principal Executive Offices)	(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.

Yes x No ¨

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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 ý 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 x

Number of shares outstanding of each of the issuer's classes of common stock, as of May 14, 2010: 3,413,099 shares, par value $.01.

1

Table of Contents

Part I – Financial Information

Part II – Other Information

2

PART 1 - FINANCIAL INFORMATION

Item 1. Financial Statements

Mexican Restaurants, Inc. and Subsidiaries
Consolidated Balance Sheets

ASSETS		(Unaudited) 4/4/2010		1/3/2010
Current assets:				
Cash	$	694,071	$	719,944
Royalties receivable		96,354		61,194
Other receivables		572,997		639,019
Inventory		584,966		562,682
Income taxes receivable		216,219		284,724
Prepaid expenses and other current assets		798,642		1,065,056
Assets related to discontinued operations		173,708		161,523
Total current assets		3,136,957		3,494,142
Property and equipment, net		17,155,625		17,491,335
Goodwill		5,017,243		5,017,243
Deferred tax assets		1,902,785		1,542,999
Other assets		134,837		147,667
Other assets related to discontinued operations		33,878		33,878
Total Assets	$	27,381,325	$	27,727,264
LIABILITIES AND STOCKHOLDERS' EQUITY				
Current liabilities:				
Accounts payable	$	2,603,969	$	1,929,864
Accrued sales, liquor, and payroll taxes		981,030		979,735
Accrued expenses		693,954		1,104,185
Current liabilities related to discontinued operations		7,437		39,554
Current portion of liabilities associated with leasing and exit activities		149,286		107,381
Total current liabilities		4,435,676		4,160,719
Long-term debt		4,550,000		5,150,000
Liabilities associated with leasing and exit activities, net of current portion		706,864		611,392
Deferred gain		676,464		728,500
Deferred rent and other liabilities		2,161,237		2,149,313
Total Liabilities		12,530,241		12,799,924

Commitments & 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		47,327		47,327
shares outstanding at 4/4/2010 and 1/3/2010, respectively				
Additional paid-in capital		18,624,185		19,390,702
Retained earnings		7,873,039		8,272,186
Treasury stock at cost of 1,319,606 and 1,442,564 common shares at 4/4/10 and 1/3/10, respectively		(11,693,467)		(12,782,875)
Total stockholders' equity		14,851,084		14,927,340
Total Liabilities and Stockholders' Equity	$	27,381,325	$	27,727,264

See accompanying notes to consolidated financial statements.

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

	13-Week Period Ended 4/4/2010	13-Week Period Ended 3/29/2009
Revenues:		
Restaurant sales	$16,853,074	$19,013,557
Franchise fees, royalties and other	123,912	138,289
	16,976,986	19,151,846
Costs and expenses:		
Cost of sales	4,944,913	5,250,244
Labor	5,817,086	6,122,989
Restaurant operating expenses	4,384,888	4,782,338
General and administrative	1,448,500	1,686,730
Depreciation and amortization	858,366	867,957
Impairment and restaurant closure expense	5,221	22,453
Gain on involuntary disposals	--	(7,231)
Loss on sale of property and equipment	3,715	36,762
	17,462,689	18,762,242
Operating income (loss)	(485,703)	389,604
Other income (expense):		
Interest income	11,783	980
Interest expense	(61,769)	(62,194)
Other, net	18,568	10,501
	(31,418)	(50,713)
Income (loss) from continuing operations before income taxes	(517,121)	338,891
Income tax (expense) benefit	221,690	(65,808)
Income (loss) from continuing operations	(295,431)	273,083
Discontinued Operations:		
Income from discontinued operations	--	75,456
Restaurant closure expense	(181,543)	(190,572)
Loss on sale of assets	--	(581)
Loss from discontinued operations before income taxes	(181,543)	(115,697)
Income tax benefit	77,827	22,467
Loss from discontinued operations	(103,716)	(93,230)
Net income (loss)	$(399,147)	$179,853

Basic income (loss) per common share		
Income (loss) from continuing operations	$(0.09)	$0.08
Loss from discontinued operations	(0.03)	(0.03)
Net income (loss)	$(0.12)	$0.05
Diluted income (loss) per common share		
Income (loss) from continuing operations	$(0.09)	$0.08
Loss from discontinued operations	(0.03)	(0.03)
Net income (loss)	$(0.12)	$0.05
Weighted average number of common shares (basic)	3,309,628	3,269,341
Weighted average number of common shares (diluted)	3,309,628	3,270,057

See accompanying notes to consolidated financial statements.

4

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

	13-Week Period Ended 4/4/2010	13-Week Period Ended 3/29/2009
Cash flows from operating activities:		
Net income (loss)	$(399,147)	$179,853
Loss from discontinued operations	103,716	93,230
Income (loss) from continuing operations	(295,431)	273,083
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	858,366	867,957
Deferred gain amortization	(52,035)	(52,035)
Impairment and restaurant closure expense	5,221	22,453
Other non-cash income	(16,454)	--
Gain on involuntary disposals	--	(7,231)
Loss on sale of property & equipment	3,715	36,762
Stock based compensation expense	44,919	52,805
Deferred income tax benefit	(359,786)	(65,992)
Changes in operating assets and liabilities, net of effects of business acquisitions:		
Royalties receivable	(35,160)	57,058
Other receivables	66,022	(21,700)
Inventory	(22,284)	26,017
Income taxes receivable	146,332	109,333
Prepaid and other current assets	266,414	171,908
Other assets	2,192	(22,428)
Accounts payable	674,105	(236,735)
Accrued expenses and other liabilities	(408,936)	(355,042)
Liabilities associated with leasing and exit activities	(44,166)	(22,113)
Deferred rent and other long-term liabilities	11,924	(16,061)
Total adjustments	1,140,389	544,956
Net cash provided by continuing operations	844,958	818,039
Net cash used in discontinued operations	(44,302)	(62,073)
Net cash provided by operating activities	800,656	755,966
Cash flows from investing activities:		
Insurance proceeds received from involuntary disposals	--	54,731
Purchase of property and equipment	(511,525)	(716,618)
Proceeds from sale of property and equipment	7,024	--
Net cash used in continuing operations	(504,501)	(661,887)
Net cash used in discontinued operations	--	(5,980)
Net cash used in investing activities	(504,501)	(667,867)
Cash flows from financing activities:		
Borrowings under line of credit agreement	650,000	600,000
Payments under line of credit agreement	(1,250,000)	(500,000)
Issuance of common stock from treasury	277,972	--
Net cash provided by (used in) financing activities	(322,028)	100,000

Net increase (decrease) in cash	(25,873)	188,099
Cash at beginning of period	719,944	879,206
Cash at end of period	$694,071	$1,067,305
Supplemental disclosure of cash flow information:		
Cash paid during the period:		
Interest	$59,042	$71,081
Income taxes	$--	$--

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 April 4, 2010, and the consolidated statements of operations and cash flows for the 13-week periods ended April 4, 2010 and March 29, 2009. The consolidated statement of operations for the 13-week period ended April 4, 2010 is 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 April 4, 2010, we had one equity-based compensation plan from which stock-based compensation awards can be granted to eligible employees, officers or directors, known as the 2005 Long Term Incentive Plan. On May 28, 2008, the shareholders approved an amendment to the 2005 Long Term Incentive Plan to increase from 350,000 to 425,000 shares 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.

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.

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 periods ended April 4, 2010 and March 29, 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 April 4, 2010, weighted-average shares outstanding, assuming dilution, excludes the impact of 1,089 common stock equivalents, respectively, due to our net loss position in the period. For the 13-week period ended March 29, 2009, weighted-average shares outstanding included 716 common stock equivalents in the calculation of diluted income per share.

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. For the second quarter of fiscal year 2011 and thereafter the fixed charge coverage ratio is increased to 1.20 and the interest rate reamins at LIBOR plus 325. As amended, we were in compliance with all debt covenants of the Wells Fargo Agreement at April 4, 2010.

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

6. Related Party Transactions

Our Vice Chairman of the Board of Directors owns a Casa Olé franchise restaurant for which the Company receives royalties. For the 13-week periods ended April 4, 2010 and March 29, 2009, the Company recognized royalty income of $5,582 and $6,110, 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 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.

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. We recorded a gain on this sale of $387,083 in fiscal year 2009, net of allocated goodwill, in the second quarter of 2009. Proceeds from the sale were used to pay down long-term debt. On January 24, 2009, we closed one underperforming Mission Burrito restaurant. The results of operations for the first quarter of fiscal year 2009 for the La Senorita chain and the closed Mission Burrito restaurant have been reported as discontinued operations. During the first quarter of fiscal year 2009, we recognized a net loss from discontinued operations of $93,230 from the sale of the chain and the closure of the Mission Burrito restaurant. Income from discontinued operations of $75,456 during the first quarter of fiscal year 2009 reflects operating income from the La Senorita restaurants, partially offset by operating losses from the closed Mission Burrito restaurant. Restaurant closure costs of $190,572, during the first quarter of fiscal year 2009, primarily reflect costs associated with the closure of the Mission Burrito restaurant. Neither the La Senorita restaurant chain nor the closed Mission Burrito restaurant had any operations during the first quarter of fiscal year 2010.

7

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. Amendment No. 5 to the Wells Fargo Agreement was signed on May 17, 2010 and was effective for the first quarter ended April 4, 2010.

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 simila 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 April 4, 2010 we operated 55 restaurants, franchised 17 restaurants and licensed one restaurant in various communities in Texas, Louisiana and Oklahoma. During the second quarter of 2010 one franchise location will close.

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.

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

Results of Operations

Revenues. Our restaurant revenues for the first quarter of fiscal year 2010 decreased $2.2 million or 11.4% to $17.0 million compared with $19.2 million for the same quarter in fiscal year 2009. The decrease in restaurant revenues primarily reflects a decrease in same-store sales. For the first quarter ended April 4, 2010, Company-owned same-restaurant sales decreased approximately 11.7%. Franchised-owned restaurant sales, as reported by franchisees, decreased approximately 11.0% over the same quarter 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 first quarter of fiscal year 2010 compared with 27.6% for the first quarter 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 expense, were approximately $600,000 lower in the first quarter ended April 4, 2010 compared with the first quarter of fiscal year 2009, resulting in a 70 basis point increase in cost of sales. In absolute dollars, cost of sales decreased $305,331 compared with the first quarter of fiscal year 2009.

Labor and other related expenses for the first quarter of fiscal 2010 increased as a percentage of restaurant sales 230 basis points to 34.5% as compared with 32.2% in the first quarter of fiscal year 2009. The increase reflects labor cost leverage that is lost when same-store sales decline. Management labor increased 50 basis points, hourly labor increased 120 basis points and employee taxes increased 60 basis points. The increase in hourly 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 $305,903 compared with the first quarter 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 80 basis points to 26.0% for the first quarter of fiscal 2010 as compared with 25.2% in the first quarter of fiscal year 2009. The increase reflects cost leverage that is lost when same-store sales decline. Offsetting some of the increase, first quarter utilities and advertising expenses were approximately $125,000 and $200,000, respectively, lower than the first quarter of fiscal year 2009. In absolute dollars, restaurant operating expenses decreased $397,450 compared with the first quarter 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 30 basis points to 8.5% for the first quarter of fiscal year 2010 as compared with 8.8% for the first quarter of fiscal year 2009. In absolute dollars, general and administrative costs decreased $238,230 compared with the first quarter of fiscal year 2009. General and administrative expenses decreased both as a percentage of total revenues and in absolute dollars due to the planned reduction 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 60 basis points to 5.1% for the first quarter of fiscal year 2010 as compared with 4.5% the same quarter in fiscal year 2009. Such expense for the first quarter of fiscal year 2010 was $9,591 lower than the first quarter 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 period ended April 4, 2010 and March 29, 2009, includes a separate line item for impairment and restaurant closure expense of $5,221 and $22,453, respectively. The impairment and restaurant closure expense primarily related to two under-performing restaurants operating in the Houston area.

Loss on Sale of Property and Equipment. The consolidated statements of operations for the 13-week period ended April 4, 2010 include a separate line item for a loss of $3,715, primarily related to the routine disposal of restaurant assets. The consolidated statements of operations for the 13-week period ended March 29, 2009 includes a separate line item for a loss of $36,762, primarily related to the disposal of restaurant assets.

Other Income (Expense). Net expense decreased $19,295 to $31,418 in the 13-week period ended April 4, 2010 compared with a net expense of $50,713 in the 13-week period ended March 29, 2009. Interest expense decreased $425 to $61,769 in the 13-week period ended April 4, 2010 compared with interest expense of $62,194 in the 13-week period ended March 29, 2009. Average quarterly debt was approximately $3.0 million lower in the first quarter of fiscal year 2010 compared with first quarter 2009. The small decrease in interest expense reflects higher interest rates in the first quarter of fiscal year 2010 compared with interest rates in the first quarter of fiscal year 2009 offset by lower average debt outstanding for the first quarter 2010.

Income Taxes. Our effective tax rate from continuing and discontinued operations for the 13-week period ended April 4, 2010 was a benefit of 42.9% as compared to an expense of 19.4% for the 13-week period ended March 29, 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 April 4, 2010.

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. We recorded a gain on this sale of $387,083 in fiscal year 2009, net of allocated goodwill, in the second quarter of 2009. Proceeds from the sale were used to pay down long-term debt. On January 24, 2009, we closed one underperforming Mission Burrito restaurant. The results of operations for the first quarter of fiscal year 2009 for the La Senorita chain and the closed Mission Burrito restaurant have been reported as discontinued operations. During the first quarter of fiscal year 2009, we recognized a net loss from discontinued operations of $93,230 from the sale of the chain and the closure of the Mission Burrito restaurant. Income from discontinued operations of $75,456 during the first quarter of fiscal year 2009 reflects operating income from the La Senorita restaurants, partially offset by operating losses from the closed Mission Burrito restaurant. Restaurant closure costs of $190,572, during the first quarter of fiscal year 2009, primarily reflect costs associated with the closure of the Mission Burrito restaurant. Neither the La Senorita restaurant chain nor the closed Mission Burrito restaurant had any operations during the first quarter of fiscal year 2010.

Liquidity and Capital Resources

We financed our capital expenditure requirements for the 13-week period ended April 4, 2010 primarily from our operating cash flows. In the 13-week period of fiscal year 2010, we had cash flows provided by operating activities of approximately $800,000, compared with cash flows provided by operating activities of approximately $756,000 in the comparable 13-week period of fiscal year 2009. During the 13-week period ended April 4, 2010, we made draws of $650,000 and payments of $1,250,000 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 April 4, 2010, we had a working capital deficit of approximately $1.3 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 13-week period ended April 4, 2010, total cash used for capital requirements, net of proceeds from sale of property and equipment, was $504,501, all used for continuing operations. Total cash used for capital requirements included $493,331 spent for routine capital expenditures and $18,194 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 $1.5 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. 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. As amended, we were in compliance with all debt covenants of the Wells Fargo Agreement at April 4, 2010.

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

We are subject to a non-use fee of 0.50% on the unused portion of the revolver from the date of the Wells Fargo Agreement. The Wells Fargo Agreement also allows up to $2.0 million in annual stock repurchases. We have pledged the stock of our subsidiaries, our leasehold interests, our patents and trademarks and our furniture, fixtures and equipment as collateral for our credit facility with Wells Fargo.

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

On April 7, 2009, we sold substantially all of the operating assets and liabilities of our La Senorita 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 Senorita 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 April 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 April 4, 2010, there was $4.55 million outstanding under the revolving credit facility which currently bears interest at 275 basis points (depending on leverage ratios) over LIBOR. Should interest rates based on these borrowings increase by one percentage point, estimated quarterly interest expense would increase by approximately $11,000.

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 subprime mortgage crisis, subsequent disruptions to the financial markets, and continuing economic downturn may adversely impact the availability of credit already arranged and the availability and cost of credit in the future. The disruptions in the financial markets have had an adverse effect on the U.S. and world economy, and have negatively impacted recent consumer spending patterns. There can be no assurance that various U.S. and world government responses to the disruptions in the financial markets in the near future will restore consumer confidence, stabilize the markets, or increase liquidity or the availability of credit. Our future performance could be hindered by our accessibility to obtain financing.

Item 4T. Controls and Procedures

Evaluation of Controls and Procedures

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

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

Changes in Internal Control Over Financial Reporting

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

PART II - OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes in the Company’s risk factors from the disclosure set forth in our Annual Report on Form 10-K for the fiscal year ended 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

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 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.

Item 6. Exhibits

Exhibit Number	Document Description
10.1	Agreement and Amendment No. 5 to Credit Agreement made as of May 17, 2010, between Mexican Restaurants, Inc. and Wells Fargo Bank, N.A. amending the Credit Agreement between the Company and Wells Fargo dated June 29, 2007
31.1	Certification of Chief Executive Officer Filed Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of Chief Financial Officer Filed Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of Chief Executive Officer Forwarded Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Forwarded Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Items 1, 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: May 18, 2010 By: /s/ Curt Glowacki

Curt Glowacki
Chief Executive Officer
(Principal Executive Officer)

Dated: May 18, 2010 By: /s/ Andrew J. Dennard

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