

ALEXANDERS J CORP
Form 10-Q
May 15, 2006

Table of Contents

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q**

(Mark One)

QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For quarterly period ended April 2, 2006

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 1-8766

J. ALEXANDER S CORPORATION

(Exact name of registrant as specified in its charter)

Tennessee

62-0854056

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

3401 West End Avenue, Suite 260, P.O. Box 24300, Nashville, Tennessee 37202

(Address of principal executive offices)

(Zip Code)

(615)269-1900

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (check one):

Large accelerated filer Accelerated filer Non-accelerated filer

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

Yes No

Common Stock Outstanding 6,540,372 shares at May 15, 2006.

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

PART II. OTHER INFORMATION

Item 6. Exhibits

SIGNATURES

INDEX TO EXHIBITS

Ex-31.1 Section 302 Certification of the CEO

Ex-31.2 Section 302 Certification of the CFO

Ex-32.1 Section 906 Certification of the CEO & CFO

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****J. Alexander's Corporation and Subsidiaries****Condensed Consolidated Balance Sheets****(Unaudited in thousands, except share and per share amounts)**

	April 2 2006	January 1 2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 8,515	\$ 8,200
Accounts and notes receivable	1,797	1,907
Inventories	1,377	1,351
Deferred income taxes	964	964
Prepaid expenses and other current assets	1,101	1,284
TOTAL CURRENT ASSETS	13,754	13,706
OTHER ASSETS	1,237	1,164
PROPERTY AND EQUIPMENT , at cost, less allowances for depreciation and amortization of \$39,125 and \$37,940 at April 2, 2006, and January 1, 2006, respectively	73,468	74,187
DEFERRED INCOME TAXES	4,510	4,510
DEFERRED CHARGES , less amortization	718	733
	\$ 93,687	\$ 94,300

Table of Contents

	April 2 2006	January 1 2006
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Accounts payable	\$ 3,651	\$ 4,971
Accrued expenses and other current liabilities	4,731	4,817
Unearned revenue	1,664	2,285
Current portion of long-term debt and obligations under capital leases	840	824
TOTAL CURRENT LIABILITIES	10,886	12,897
LONG-TERM DEBT AND OBLIGATIONS UNDER CAPITAL LEASES, net of portion classified as current	22,971	23,193
OTHER LONG-TERM LIABILITIES	5,243	5,103
STOCKHOLDERS EQUITY		
Common Stock, par value \$.05 per share: Authorized 10,000,000 shares; issued and outstanding 6,537,372 and 6,531,122 shares at April 2, 2006, and January 1, 2006, respectively	327	327
Preferred Stock, no par value: Authorized 1,000,000 shares; none issued		
Additional paid-in capital	34,663	34,620
Retained earnings	19,973	18,536
	54,963	53,483
Employee notes receivable 1999 Loan Program	(376)	(376)
TOTAL STOCKHOLDERS EQUITY	54,587	53,107
	\$ 93,687	\$ 94,300

See notes to condensed consolidated financial statements.

Table of Contents**J. Alexander's Corporation and Subsidiaries
Condensed Consolidated Statements of Income
(Unaudited in thousands, except per share amounts)**

	Quarter Ended	
	April 2 2006	April 3 2005
Net sales	\$ 35,238	\$ 32,154
Costs and expenses:		
Cost of sales	11,549	10,764
Restaurant labor and related costs	10,999	9,990
Depreciation and amortization of restaurant property and equipment	1,298	1,188
Other operating expenses	6,797	6,221
Total restaurant operating expenses	30,643	28,163
General and administrative expenses	2,391	2,290
Operating income	2,204	1,701
Other income (expense):		
Interest expense, net	(425)	(462)
Other, net	29	11
Total other expense	(396)	(451)
Income before income taxes	1,808	1,250
Income tax provision	(371)	(301)
Net income	\$ 1,437	\$ 949
Basic earnings per share	\$.22	\$.15
Diluted earnings per share	\$.21	\$.14

See notes to condensed consolidated financial statements.

Table of Contents
J. Alexander's Corporation and Subsidiaries
Condensed Consolidated Statements of Cash Flows
(Unaudited in thousands)

	Quarter Ended	
	April 2 2006	April 3 2005
Net cash provided by operating activities:		
Net income	\$ 1,437	\$ 949
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of property and equipment	1,320	1,209
Changes in working capital accounts	99	(1,432)
Other operating activities	233	320
	3,089	1,046
Net cash used in investing activities:		
Purchase of property and equipment	(1,115)	(956)
Other investing activities	(72)	(66)
	(1,187)	(1,022)
Net cash (used in) provided by financing activities:		
Payments on debt and obligations under capital leases	(206)	(198)
(Decrease) increase in bank overdraft	(745)	1,764
Payment of cash dividend	(653)	
Other	17	6
	(1,587)	1,572
Increase in cash and cash equivalents	315	1,596
Cash and cash equivalents at beginning of period	8,200	6,129
Cash and cash equivalents at end of period	\$ 8,515	\$ 7,725
Supplemental disclosures of non-cash items:		
Property and equipment obligations accrued at beginning of period	\$ 550	\$ 123
Property and equipment obligations accrued at end of period	\$ 89	\$ 95
See notes to condensed consolidated financial statements.		

Table of Contents

J. Alexander's Corporation and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Unaudited)

NOTE A BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain reclassifications have been made in the prior year's condensed consolidated financial statements to conform to the 2006 presentation. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the quarter ended April 2, 2006, are not necessarily indicative of the results that may be expected for the fiscal year ending December 31, 2006. For further information, refer to the consolidated financial statements and footnotes thereto included in the J. Alexander's Corporation (the Company's) Annual Report on Form 10-K for the fiscal year ended January 1, 2006.

Net income and comprehensive income are the same for all periods presented.

NOTE B ACCOUNTS RECEIVABLE

The Company receives payment from third party credit card issuers for purchases made by guests using the issuers credit cards. The issuers typically pay the Company within three to four days of a credit card transaction. Prior to the second quarter of 2005, the amounts receivable from the issuers were treated as in-transit cash deposits. Effective beginning July 3, 2005, these amounts have been classified as accounts receivable. For consistency of presentation, the Condensed Consolidated Statement of Cash Flows for the quarter ended April 3, 2005 has been reclassified to reflect the impact of this change of classification.

NOTE C CASH OVERDRAFT

As a result of utilizing a consolidated cash management system, the Company's books reflect an overdraft position with respect to accounts maintained at its primary bank at various times throughout the year. Overdraft balances, which were included in accounts payable, totaled \$2,317,000 and \$1,572,000 at January 1, 2006 and April 2, 2006, respectively. The Condensed Consolidated Statement of Cash Flows for the quarter ended April 3, 2005 has been reclassified to reflect the impact of cash overdrafts of \$635,000 and \$2,399,000 at January 2, 2005 and April 3, 2005, respectively.

NOTE D EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share:

Table of Contents

	Quarter Ended	
	April 2 2006	April 3 2005
Numerator:		
Net income (numerator for basic earnings per share)	\$ 1,437,000	\$ 949,000
Effect of dilutive securities		
Net income after assumed conversions (numerator for diluted earnings per share)	\$ 1,437,000	\$ 949,000
Denominator:		
Weighted average shares (denominator for basic earnings per share)	6,533,000	6,461,000
Effect of dilutive securities:		
Employee stock options	288,000	322,000
Adjusted weighted average shares and assumed conversions (denominator for diluted earnings per share)	6,821,000	6,783,000
Basic earnings per share	\$.22	\$.15
Diluted earnings per share	\$.21	\$.14

For the quarter ended April 2, 2006, options to purchase 401,000 shares of common stock were excluded from the computation of diluted earnings per share due to their antidilutive effect. During the corresponding period of 2005, options to purchase 109,000 shares of common stock were similarly excluded from the computation of diluted earnings per share.

NOTE E INCOME TAXES

Income tax expense for the first quarter of 2006 has been provided for based on an estimated effective tax rate of 24.2% expected to be applicable for the 2006 fiscal year. Also included in the tax provision for the first quarter of 2006 is a favorable adjustment of \$67,000 which represents a discrete item related to correction of a prior year's federal income tax return. The effective income tax rate differs from applying the statutory federal income tax rate of 34% to pre-tax earnings primarily due to the effect of employee FICA tip tax credits (a reduction in income tax expense) partially offset by the effect of state income taxes.

NOTE F STOCK BASED COMPENSATION

Under the Company's 2004 Equity Incentive Plan, directors, officers and key employees of the Company may be granted options to purchase shares of the Company's common stock. Options to purchase the Company's common stock also remain outstanding under the Company's 1994 Employee Stock Incentive Plan and the 1990 Stock Option Plan for Outside Directors, although the Company no longer has the ability to issue additional shares under these plans.

Effective January 2, 2006, the Company adopted the provisions of Financial Accounting Standards Board Statement of Financial Accounting Standards (SFAS) No. 123 (revised), Share-Based Payment (SFAS 123R) using a modified prospective application. Prior to the adoption of SFAS 123R, the Company accounted for share-based payments to employees using the intrinsic value method under Accounting Principles Board Opinion No. 25,

Accounting for Stock Issued to Employees (APB 25). Under the provisions of APB 25, stock

Table of Contents

option awards were generally accounted for using fixed plan accounting whereby the Company recognized no compensation expense for stock option awards because the exercise price of options granted was equal to the fair value of the common stock at the date of grant.

Under the modified prospective application, the provisions of SFAS 123R apply to non-vested awards which were outstanding on January 1, 2006 and to new awards and the modification, repurchase or cancellation of awards after January 1, 2006. Under the modified prospective approach, compensation expense recognized in the first quarter of 2006 includes share-based compensation cost for all share-based payments granted prior to, but not yet vested as of January 2, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), and recognized as expense over the remaining requisite service period. Compensation expense recognized in the first quarter of 2006 also includes compensation cost for all share-based payments granted subsequent to January 2, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R and recognized as expense over the applicable requisite service period. Prior periods were not restated to reflect the impact of adopting the new standard.

As a result of adopting SFAS 123R on January 2, 2006, the Company's income before taxes for the quarter ended April 2, 2006 was \$26,000 lower, and net income \$20,000 lower, than if the Company had continued to account for stock-based compensation under the provisions of APB 25. The adoption of SFAS 123R had no cumulative change effect on reported basic and diluted earnings per share. At April 2, 2006, the Company had \$143,000 of unrecognized compensation cost related to share-based payments which is expected to be recognized as follows:

2006	\$ 47,000
2007	23,000
2008	23,000
2009	23,000
2010	23,000
2011	4,000

The following table illustrates the effect on operating results and per share information had the Company accounted for stock-based compensation in accordance with SFAS 123 for the quarter ended April 3, 2005:

Net income as reported	\$ 949,000
Deduct: Stock-based employee compensation expense determined under a fair value method for all awards, net of taxes	(34,000)
Pro forma net income	\$ 915,000
Net income per share:	
Basic earnings per share, as reported	\$.15
Basic earnings per share, pro forma	\$.14
Diluted earnings per share, as reported	
Diluted earnings per share, as reported	\$.14
Diluted earnings per share, pro forma	\$.13

Table of Contents

The Company uses the Black-Scholes option pricing model to estimate the fair value of stock-based awards with the following weighted-average assumptions for the indicated periods:

	Quarter Ended	
	April 2, 2006	April 3, 2005
Dividend yield	0.64%	%
Volatility factor	.4036	.4074
Risk-free interest rate	3.91%	4.23%
Expected life of options (in years)	8.12	10.00
Weighted-average grant-date fair value	\$ 2.92	\$ 2.91

The assumptions above are generally based on anticipated future exercise patterns of employees and historical volatility of the Company's common stock calculated based on monthly closing prices since August, 1990. Risk-free interest rates are based on U.S. treasury constant maturity yields in effect as of each grant date for treasury securities with maturities approximating the expected life of options granted.

The following table represents stock option activity for the quarter ended April 2, 2006:

	Number of Shares	Weighted- Average Exercise Price	Weighted- Average Remaining Contractual Life
Outstanding options at beginning of period	868,143	\$ 5.45	
Granted	94,000	8.21	
Exercised	(6,250)	2.57	
Forfeited	(1,333)	4.25	
Outstanding options at end of period	954,560	\$ 5.74	6.0 years
Outstanding exercisable at end of period	834,216	\$ 5.48	5.6 years

There were 93,502 shares available for future grants to employees and directors under the 2004 Equity Incentive Plan at April 2, 2006. The aggregate intrinsic value of options outstanding at April 2, 2006 was \$2.5 million, and the aggregate intrinsic value of options exercisable was \$2.2 million. The total intrinsic value of options exercised was \$10,000 and \$2,000 for the quarters ended April 2, 2006 and April 3, 2005, respectively.

The following table summarizes the Company's non-vested stock option activity for the quarter ended April 2, 2006:

	Number of Shares	Weighted- Average Grant-Date Fair Value
Non-vested stock options at beginning of period	26,344	\$ 2.88
Granted	94,000	3.25
Vested		
Forfeited		

Non-vested stock options at end of period	120,344	\$	3.17
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Table of Contents

NOTE G COMMITMENTS AND CONTINGENCIES

As a result of the disposition of its Wendy's operations in 1996, the Company remains secondarily liable for certain real property leases with remaining terms of one to ten years. The total estimated amount of lease payments remaining on these 24 leases at April 2, 2006 was approximately \$3.5 million. In connection with the sale of its Mrs. Winner's Chicken & Biscuit restaurant operations in 1989 and certain previous dispositions, the Company also remains secondarily liable for certain real property leases with remaining terms of one to five years. The total estimated amount of lease payments remaining on these 27 leases at April 2, 2006, was approximately \$2.1 million. Additionally, in connection with the previous disposition of certain other Wendy's restaurant operations, primarily the southern California restaurants in 1982, the Company remains secondarily liable for certain real property leases with remaining terms of one to five years. The total estimated amount of lease payments remaining on these 11 leases as of April 2, 2006, was approximately \$1.4 million.

The Company is from time to time subject to routine litigation incidental to its business. The Company believes that the results of such legal proceedings will not have a materially adverse effect on the Company's financial condition, operating results or liquidity.

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations
RESULTS OF OPERATIONS

Overview

J. Alexander's Corporation (the Company) operates upscale casual dining restaurants. At April 2, 2006, the Company operated 28 J. Alexander's restaurants in 12 states. The Company's net sales are derived primarily from the sale of food and alcoholic beverages in its restaurants. Revenues are also generated by the sale and redemption of gift cards, and from other income related to gift cards and certificates.

The Company's strategy is for J. Alexander's restaurants to compete in the restaurant industry by providing guests with outstanding professional service, high quality food, and an attractive environment with an upscale, high-energy ambiance. Quality is emphasized throughout J. Alexander's operations and substantially all menu items are prepared on the restaurant premises using fresh, high quality ingredients. The Company's goal is for each J. Alexander's restaurant to be perceived by guests in its market as a market leader in each of the categories above. J. Alexander's restaurants offer a contemporary American menu designed to appeal to a wide range of consumer tastes. However, the Company believes its restaurants are most popular with more discriminating guests with higher discretionary incomes. J. Alexander's typically does not advertise in the media and relies on each restaurant to increase sales by building its reputation as an outstanding dining establishment. The Company has generally been successful in achieving sales increases in its restaurants over time using this strategy.

The restaurant industry is highly competitive and is often affected by changes in consumer tastes and discretionary spending patterns; changes in general economic conditions; public safety conditions or concerns; demographic trends; weather conditions; the cost of food products, labor and energy; and governmental regulations. Because of these factors, the Company's management believes it is of critical importance to the Company's success to effectively execute the Company's operating strategy and to constantly evolve and refine the critical conceptual elements of J. Alexander's restaurants in order to distinguish them from other casual dining competitors and maintain the Company's competitive position.

The restaurant industry is also characterized by high capital investment for new restaurants and relatively high fixed or semi-variable restaurant operating expenses. As a result, incremental sales in existing restaurants are generally expected to make a significant contribution to restaurant profitability because many restaurant costs and expenses are not expected to increase at the same rate as sales. Improvements in profitability resulting from incremental sales growth can be affected, however, by inflationary increases in operating costs and other factors. Management believes that excellence in restaurant operations, and particularly providing exceptional guest service, will increase net sales in the Company's existing restaurants and will support menu pricing levels which allow the Company to achieve reasonable operating margins while absorbing the higher costs of providing high quality dining experiences and operating cost increases.

Table of Contents

Incremental sales for existing restaurants are generally measured in the restaurant industry by computing the same store sales increase, which represents the increase in sales for the restaurants included in the same base of restaurants for comparable periods. Same store sales increases can be generated by increases in guest counts and increases in the average check per guest. The average check per guest can be affected by menu price changes and the mix of menu items sold. Management regularly analyzes guest count and average check trends for each restaurant in order to improve menu pricing and product offering strategies. Management believes that it is important to increase guest counts and average guest checks over time in order to continue to improve the Company's profitability. The Company works to balance menu price increases with product offering and margin considerations in its efforts to achieve sustainable long-term increases in same store sales.

Other key indicators which can be used to evaluate and understand the Company's restaurant operations include cost of sales, restaurant labor and related costs and other operating expenses, with a focus on these expenses as a percentage of net sales. The cost of beef is the largest component of the Company's cost of sales. The Company typically enters into an annual pricing agreement which sets the price the Company will pay for beef for a 12 month period. Since the Company uses primarily fresh ingredients for food preparation, the cost of other food commodities can vary significantly from time to time due to a number of factors. The Company generally expects to increase menu prices in order to offset the increase in the cost of food products as well as increases which the Company experiences in labor and related costs and other operating expenses, but attempts to balance these increases with the goals of providing reasonable value to the Company's guests and maintaining same store sales growth. Management believes that restaurant operating margin, which is computed by subtracting total restaurant operating expenses from net sales and dividing by net sales, is an important indicator of the Company's success in managing its restaurant operations because it is affected by same store sales growth, menu pricing strategy, and the management and control of restaurant operating expenses in relation to net sales.

The opening of new restaurants by the Company can have a significant impact on the Company's financial performance. Because pre-opening costs for new restaurants are significant and most new restaurants incur start-up losses during their early months of operation, the number of restaurants opened or under development in a particular year can have a significant impact on the Company's operating results. The Company has historically capitalized rents paid during the period a restaurant is under construction. Beginning in fiscal 2006, any straight-line minimum rent expense incurred during the construction period for any new leased restaurant locations for which construction begins will be included in pre-opening expense.

Because large capital investments are required for J. Alexander's restaurants and because a significant portion of labor costs and other operating expenses are fixed or semi-fixed in nature, management believes the sales required for a J. Alexander's restaurant to break even are relatively high compared to many other casual dining concepts and it is necessary for the Company to achieve relatively high sales volumes in its restaurants in order to achieve desired financial returns. The Company's criteria for new restaurant development target locations with high population densities and high household incomes which management believes provide the best prospects for achieving attractive financial returns on the Company's investments in new restaurants. Management believes that its intended new restaurant development rate of two to three restaurants per year beginning in 2007 should allow the Company to acquire new locations which meet the Company's development criteria while also allowing management to focus

Table of Contents

intently on improving sales and profits in its existing restaurants and maintain its pursuit of operational excellence. No new restaurant openings are currently planned in 2006.

While the Company's earnings for the first quarter of 2006 were significantly higher than for the first quarter of 2005, management believes that earnings comparisons for the second quarter of 2006 to the second quarter of 2005 will be difficult because of the reduction in cost of sales as a percentage of net sales and other operating efficiencies achieved in the second quarter of 2005. Operating expenses are expected to continue to be under pressure in 2006 from increases in utility costs, and training and other general and administrative expenses are expected to be higher in the second quarter of 2006. In addition, the Company like some other restaurant companies has experienced weakness in same store sales growth in recent weeks, with declines in the Company's Midwestern markets contributing most notably to the weakness. As a result, management currently expects that same store sales growth in the second quarter of 2006 compared to the second quarter of 2005 will be less than the 5.1% increase experienced in the first quarter of 2006 compared to the same quarter of 2005. Because of the factors discussed above, the Company currently expects earnings for the second quarter of 2006 to be below those for the second quarter of the previous year, although earnings for the first half of 2006 are expected to be above those for the first half of 2005.

The following table sets forth, for the periods indicated, (i) the items in the Company's Condensed Consolidated Statements of Income expressed as a percentage of net sales, and (ii) other selected operating data:

	Quarter Ended	
	April 2 2006	April 3 2005
Net sales	100.0%	100.0%
Costs and expenses:		
Cost of sales	32.8	33.5
Restaurant labor and related costs	31.2	31.1
Depreciation and amortization of restaurant property and equipment	3.7	3.7
Other operating expenses	19.3	19.3
Total restaurant operating expenses	87.0	87.6
General and administrative expenses	6.8	7.1
Operating income	6.3	5.3
Other income (expense):		
Interest expense, net	(1.2)	(1.4)
Other, net	.1	
Total other income (expense)	(1.1)	(1.4)
Income before income taxes	5.1	3.9
Income tax provision	(1.1)	(.9)
Net income	4.1%	3.0%
Restaurants open at end of period	28	27
Weighted average weekly net sales per restaurant:		
All restaurants	\$ 96,800	\$ 91,400

Note: Certain percentage totals do not sum due to rounding.

Table of Contents

	Quarter Ended	
	April 2 2006	April 3 2005
% Increase	+5.9%	
Same store restaurants (1)	\$ 96,100	\$ 91,400
% Increase	+5.1%	

(1) Includes the twenty-seven restaurants open for more than 18 months.

Net Sales

Net sales increased by approximately \$3.1 million, or 9.6%, in the first quarter of 2006 compared to the same period of 2005. This increase was due to the 5.1% increase in net sales in the same store restaurant base and to an additional restaurant which opened in October of 2005.

The Company computes weighted average weekly sales per restaurant by dividing total restaurant sales for the period by the total number of days all restaurants were open for the period to obtain a daily sales average, with the daily sales average then multiplied by seven to arrive at weekly average sales per restaurant. Days on which restaurants are closed for business for any reason other than the scheduled closure of all J. Alexander's restaurants on Thanksgiving day and Christmas day are excluded from this calculation. Weighted average weekly same store sales per restaurant are computed in the same manner as described above except that sales and sales days used in the calculation include only those for restaurants open for more than 18 months. Revenue associated with service charges on unused gift cards and reductions in liabilities for gift certificates or cards is not included in the calculation of weighted average weekly sales per restaurant or weighted average weekly same store sales per restaurant.

Management estimates the average check per guest, including alcoholic beverage sales, increased by 6% to \$22.45 in the first quarter of 2006 from \$21.17 in the first quarter of 2005. Management estimates that menu prices increased by approximately 2.3% in the first quarter of 2006 over the same period of 2005. In addition, in April of 2005 the Company changed its menu pricing format in most locations to modified a la carte pricing for beef and seafood entrees. Under the modified a la carte format, menu prices of beef and seafood entrees which previously included a dinner salad decreased by \$1.00 to \$2.00 in many locations (although increasing in certain major market locations), but no longer include a salad. If desired, a salad can be added for an additional charge of \$4.00. Management estimates that weekly average guest counts on a same store basis, decreased by 1.1% in the first quarter of 2006 compared to the same period of 2005. Management believes that the decrease in guest counts in 2006 was due to higher menu prices and, in some locations, to trial by the Company's guests of new upscale restaurants in their markets.

Increased wine sales, which management believes are due to additional emphasis placed on the Company's wine feature program, also contributed to same store sales increases in the first quarter of 2006 compared to the first quarter of 2005.

In past years, monthly service charges were deducted from outstanding balances of gift cards after a card had no activity for 12 consecutive months. These service charges were recorded as revenue when deducted. In November of 2005, the Company discontinued service charges on gift cards and began recognizing revenue related to reductions in liabilities for gift cards and certificates which, although they do not expire, are considered to be only remotely likely to be redeemed (breakage). Revenues of \$98,000 related to gift card service fees were included in net sales for the first quarter of 2005 and breakage of \$19,000 was included in net sales for the first quarter of 2006.

Table of Contents

Restaurant Costs and Expenses

Total restaurant operating expenses decreased to 87.0% of net sales in the first quarter of 2006 from 87.6% in the corresponding period of 2005 due to lower cost of sales as a percentage of net sales. Restaurant operating margins increased to 13.0% in the first quarter of 2006 from 12.4% in the first period of 2005.

Cost of sales, which includes the cost of food and beverages, decreased to 32.8% of net sales in the first quarter of 2006 from 33.5% in the first quarter of 2005 due primarily to increases in menu prices, the change in pricing format to modified a la carte pricing for beef and seafood entrees, and lower prices paid for poultry, pork and other food commodities.

Beef purchases represent the largest component of the Company's cost of sales and comprise approximately 28% to 30% of this category. Due to high prices in the beef market, the Company's beef costs have increased significantly over the last two years. The Company typically enters into an annual pricing agreement covering most of its beef purchases. Under the Company's beef pricing agreement which was effective in March of 2005, beef prices increased by an estimated 7% to 8% over those under the previous agreement. A portion of the increase under the March 2005 agreement was due to the Company upgrading its beef program to serve only Certified Angus Beef® in all of its restaurants. Under its most recent pricing agreement effective in March of 2006, the Company will continue to serve Certified Angus Beef® or other branded high-quality choice beef in most locations. While prices increased by 5% to 6% under the new agreement, management expects to offset a significant portion of the effect of the increases by changing the purchase specifications for one cut of beef in order to increase steak cutting yields and lower the Company's effective cost of that product.

In response to escalating beef input costs as well as continuing pressure on the cost of a number of other food items, the Company increased menu prices in 2005 and also changed its pricing format for certain menu items to modified a la carte pricing in most locations as discussed above. The Company has increased menu prices by an estimated 1.5% to 2.0% in 2006 in order to maintain or improve profitability.

Restaurant labor and related costs as a percentage of net sales did not change significantly in the first quarter of 2006 compared to the same period of 2005 as the effects of higher labor costs incurred in the new restaurant opened in the fourth quarter of 2005, higher restaurant bonus accruals and higher wage rates, including those resulting from a minimum wage increase in Florida, were largely offset by the favorable effects of higher same store sales and other operating efficiencies on labor costs.

Depreciation and amortization of restau