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SHELLS SEAFOOD RESTAURANTS INC
Form 10-Q
November 12, 2003

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

FORM 10-Q

- Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Quarterly Period Ended September 28, 2003
- Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period from _____ to _____

Commission File No. 000-28258

SHELLS SEAFOOD RESTAURANTS, INC.
(Exact name of registrant as specified in its charter)

DELAWARE 65-0427966
(State or other jurisdiction of (IRS) Employer Identification Number
incorporation or organization)

16313 North Dale Mabry Highway, Suite 100, Tampa, FL 33618
(Address of principal executive offices) (zip code)

(813) 961-0944
(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 is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes No

Class	Outstanding at October 30, 2003
Common stock, \$0.01 par value	4,631,375

1

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
Index

Part I.	Financial Information	Page Number
Item 1.	Financial Statements	
	Consolidated Balance Sheets	3
	Consolidated Statements of Income	4-5

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Consolidated Statements of Cash Flows		6
Consolidated Statement of Stockholders' Equity		7
Notes to Consolidated Financial Statements		8-10
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations		11-15
Item 3. Quantitative and Qualitative Disclosures About Market Risk		15
Item 4. Controls and Procedures		15-16
Part II. Other Information		17-18
Signatures		19
Exhibit Index		20

2

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS

	(Unaudited) September 28, 2003	December 29, 2002
	-----	-----
ASSETS		
Cash	\$ 1,264,946	\$ 2,468,809
Inventories	381,456	356,434
Other current assets	541,155	266,228
Receivables from related parties	92,105	105,353
	-----	-----
Total current assets	2,279,662	3,196,824
Property and equipment, net	7,476,747	7,682,892
Goodwill	2,474,407	2,474,407
Other assets	636,964	504,529
	-----	-----
TOTAL ASSETS	\$ 12,867,780	\$ 13,858,652
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 2,074,315	\$ 2,554,854
Accrued expenses	2,539,152	3,033,086
Sales tax payable	168,055	191,853
Current portion of long-term debt	323,184	532,857
	-----	-----
Total current liabilities	5,104,706	6,312,650
Notes and deferred interest payable to related parties	2,229,174	2,123,335
Long-term debt, less current portion	1,604,014	1,760,054
Deferred rent	1,060,990	1,082,761
	-----	-----
Total liabilities	9,998,884	11,278,800
Minority partner interest	457,237	427,852
	-----	-----

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STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.01 par value; authorized 2,000,000 shares; 63,548 and 66,862 shares issued and outstanding, respectively	635	669
Common stock, \$0.01 par value; authorized 20,000,000 shares; 4,631,375 and 4,454,015 shares issued and outstanding, respectively	46,313	44,540
Additional paid-in-capital	14,303,152	14,240,576
Retained earnings (deficit)	(11,938,441)	(12,133,785)
	2,411,659	2,152,000
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY		
	\$ 12,867,780	\$ 13,858,652

See accompanying notes to consolidated financial statements.

3

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	13 Weeks Ended	
	September 28, 2003	September 29, 2002
REVENUES	\$ 10,125,143	\$ 10,965,891
COST AND EXPENSES:		
Cost of revenues	3,319,468	3,751,622
Labor and other related expenses	3,407,219	3,581,715
Other restaurant operating expenses	2,847,323	2,732,188
General and administrative expenses	903,564	966,464
Depreciation and amortization	275,793	279,303
Provision for impairment of goodwill	-	51,549
	10,753,367	11,362,841
LOSS FROM OPERATIONS	(628,224)	(396,950)
OTHER INCOME (EXPENSE):		
Interest expense	(112,668)	(130,187)
Interest income	3,072	12,866
Other expense, net	(40,727)	(52,363)
	(150,323)	(169,684)
LOSS BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	(778,547)	(566,634)
ELIMINATION OF MINORITY PARTNER INTEREST	(54,373)	(47,060)

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LOSS BEFORE PROVISION FOR INCOME TAXES	(832,920)	(613,694)
BENEFIT FROM INCOME TAXES	-	8,338
NET LOSS	\$ (832,920)	\$ (605,356)
NET LOSS PER SHARE OF COMMON STOCK:		
Basic	\$ (0.18)	\$ (0.14)
Diluted	\$ (0.18)	\$ (0.14)
AVERAGE NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,631,375	4,454,015
Diluted	4,631,375	4,454,015

See accompanying notes to consolidated financial statements.

4

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

	39 Weeks Ended	
	September 28, 2003	September 29, 2002
REVENUES	\$ 35,038,465	\$ 37,603,390
COST AND EXPENSES:		
Cost of revenues	11,469,034	12,666,305
Labor and other related expenses	10,759,888	11,420,600
Other restaurant operating expenses	8,557,059	8,447,451
General and administrative expenses	2,617,318	2,754,098
Depreciation and amortization	799,879	833,709
Provision for impairment of goodwill	-	154,647
	34,203,178	36,276,810
INCOME FROM OPERATIONS	835,287	1,326,580
OTHER INCOME (EXPENSE):		
Interest expense	(358,333)	(453,965)
Interest income	11,217	28,976
Other expense, net	(94,097)	(79,645)
	(441,213)	(504,634)
INCOME BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	394,074	821,946

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ELIMINATION OF MINORITY PARTNER INTEREST	(198,730)	(168,956)
<hr/>		
INCOME BEFORE PROVISION FOR INCOME TAXES	195,344	652,990
BENEFIT FROM INCOME TAXES	-	326,715
<hr/>		
NET INCOME	\$ 195,344	\$ 979,705
<hr/>		
NET INCOME PER SHARE OF COMMON STOCK:		
Basic	\$ 0.04	\$ 0.22
<hr/>		
Diluted	\$ 0.02	\$ 0.10
<hr/>		
AVERAGE WEIGHTED NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,559,502	4,454,015
<hr/>		
Diluted	11,168,456	10,291,316
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See accompanying notes to consolidated financial statements.

5

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	39 Weeks Ended	
	September 28, 2003	September 29, 2002
	<hr/>	<hr/>
OPERATING ACTIVITIES:		
Net income	\$ 195,344	\$ 979,705
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Loss on disposal of assets	2,874	2,616
Depreciation and amortization	799,879	833,709
Provision for impairment of goodwill	-	154,647
Minority partner interest	29,385	3,922
Changes in assets and liabilities:		
(Increase) decrease in inventories	(25,022)	72,192
Decrease in receivables from related parties	13,248	27,705
Increase in other assets	(457,383)	(228,227)
Decrease in prepaid rent	17,949	12,036
(Increase) decrease in income tax refunds receivable	(3,300)	889,027
Decrease in deferred tax asset	-	-
Decrease in accounts payable	(480,539)	(1,865,319)
Decrease in accrued expenses	(283,182)	(510,811)
Decrease in sales tax payable	(23,798)	(22,497)
Decrease in deferred rent	(21,771)	(130,580)
<hr/>		
Total adjustments	(431,660)	(761,580)
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Net cash (used in) provided by operating activities	(236,316)	218,125
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INVESTING ACTIVITIES:		
Proceeds from the sale of assets	500	1,091,324
Purchase of property and equipment	(611,084)	(433,383)
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Net cash (used in) provided by investing activities	(610,584)	657,941
<hr style="border-top: 1px dashed black;"/>		
FINANCING ACTIVITIES:		
Proceeds from debt financing	578,585	2,304,317
Repayment of debt	(935,548)	(1,621,767)
<hr style="border-top: 1px dashed black;"/>		
Net cash (used in) provided by financing activities	(356,963)	682,550
<hr style="border-top: 1px dashed black;"/>		
Net (decrease) increase in cash	(1,203,863)	1,558,616
<hr style="border-top: 1px dashed black;"/>		
CASH AT BEGINNING OF PERIOD	2,468,809	969,680
<hr style="border-top: 1px dashed black;"/>		
CASH AT END OF PERIOD	\$ 1,264,946	\$ 2,528,296
<hr style="border-top: 3px double black;"/>		
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 258,490	\$ 391,832
Bonus paid in common stock	\$ 64,315	\$ -
Cash (paid) refunds received for income taxes	\$ (3,300)	\$ 1,216,438
Note receivable on sale of assets	\$ -	\$ 100,000

See accompanying notes to consolidated financial statements.

6

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	PREFERRED STOCK		COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	
	Shares	Amount	Shares	Amount		
Balance at December 29, 2002	66,862	\$ 669	4,454,015	\$ 44,540	\$ 14,240,576	\$ (1)
Net income						
Preferred stock converted to common stock	(3,314)	(34)	16,570	166	(132)	
Common stock issued			160,790	1,607	62,708	
Balance at September 28, 2003	<hr style="border-top: 1px dashed black;"/> 63,548	<hr style="border-top: 1px dashed black;"/> \$ 635	<hr style="border-top: 1px dashed black;"/> 4,631,375	<hr style="border-top: 1px dashed black;"/> \$ 46,313	<hr style="border-top: 1px dashed black;"/> \$ 14,303,152	<hr style="border-top: 1px dashed black;"/> \$ (1)
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>

See accompanying notes to consolidated financial statements.

7

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions for Form 10-Q and, therefore, these statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. In the opinion of management, all material adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included.

The consolidated financial statements of Shells Seafood Restaurants, Inc. ("we", "us", "Shells", or the "Company") should be read in conjunction with the audited consolidated financial statements and notes thereto contained in the Form 10-K for the year ended December 29, 2002 filed with the United States Securities and Exchange Commission. Company management believes that the disclosures are sufficient for interim financial reporting purposes. Certain prior year amounts have been reclassified in the accompanying condensed consolidated financial statements to conform with the current year presentation.

NOTE 2. EARNINGS PER SHARE

The following table represents the computation of basic and diluted earnings per share of common stock as required by Financial Accounting Standards Board ("FASB") Statement No. 128, "Earnings Per Share":

For the 13 weeks ended	Sept 28, 2003	Sept 29, 2002
	-----	-----
Net loss applicable to common stock	\$ (832,920)	\$ (605,356)
	=====	=====
Weighted common shares outstanding	4,631,375	4,454,015
Basic net loss per share of common stock	\$ (0.18)	\$ (0.14)
Effect of dilutive securities:		
Warrants	-	-
Stock options	-	-
	-----	-----
Diluted weighted common shares outstanding	4,631,375	4,454,015
	-----	-----
Diluted net loss per share of common stock	\$ (0.18)	\$ (0.14)
	=====	=====
For the 39 weeks ended	Sept 28, 2003	Sept 29, 2002
	-----	-----
Net income applicable to common stock	\$ 195,344	\$ 979,705
	=====	=====
Weighted common shares outstanding	4,559,502	4,454,015
Basic net income per share of common stock	\$ 0.04	\$ 0.22
Effect of dilutive securities:		
Warrants	6,261,262	5,530,808

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Stock options	347,692	306,493
Diluted weighted common shares outstanding	11,168,456	10,291,316
Diluted net income per share of common stock	\$ 0.02	\$ 0.10

8

The loss per share calculations for the 13 weeks ended September 28, 2003 and September 29, 2002 excluded warrants and options to purchase an aggregate of 11,345,153 and 11,075,039 shares of common stock, respectively, as they were anti-dilutive.

The earnings per share calculations for the 39 weeks ended September 28, 2003 and September 29, 2002 excluded warrants and options to purchase an aggregate of 4,736,199 and 5,444,248 shares of common stock, respectively, as the exercise prices of these warrants and options were greater than the average market price of the common shares.

NOTE 3. STOCK COMPENSATION PLANS

Currently, we have four stock-based employee compensation plans. We account for these plans under the recognition and measurement principles of Accounting Principles Board Opinion 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based compensation cost is reflected in net income, as all options granted under these plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant. Had compensation cost for our stock option plans been determined based on the fair value at the grant dates consistent with recognition provisions of FASB Statement No. 123, "Accounting for Stock-Based Compensation," the effect on net income and earnings per share on a pro forma basis would have been immaterial.

NOTE 4. COMMON STOCK

On April 28, 2003, we awarded 160,790 shares of common stock to key management personnel under a management incentive plan relating to fiscal 2002 performance pursuant to the 2002 Equity Incentive Plan. Compensation expense of \$104,000 was recognized in fiscal 2002 for this stock award.

NOTE 5. NEW ACCOUNTING PRONOUNCEMENTS

In June 2002, the FASB issued Statement No. 146, "Accounting for Costs Associated with Exit or Disposal Activities." The Statement addresses costs that are a result of exiting an activity, such as termination benefits, costs to terminate a contract that is not a capital lease, and costs to consolidate facilities or relocate employees. Under the Statement, in general, a company may recognize costs related to a restructuring only when the liability is incurred. Under previous US GAAP, a liability for such costs was recognized on the date when a company committed to an exit plan. The provisions of this

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statement are effective for exits and disposal activities that are initiated after December 31, 2002. The adoption of Statement No. 146 did not materially affect our consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others." Interpretation No. 45 supersedes Interpretation No. 34, "Disclosure of Indirect Guarantees of Indebtedness of Others," and provides guidance on the recognition and disclosures to be made by a guarantor in its interim and annual financial statements about its obligations under certain guarantees. The initial recognition and measurement provisions of Interpretation No. 45 are effective for guarantees issued or modified after December 31, 2002, and are to be applied prospectively. The disclosure requirements are effective for financial statements for interim or annual periods ending after December 15, 2002. The adoption of Interpretation No. 45 did not materially affect our consolidated financial statements.

9

In November 2002, the FASB's Emerging Issues Task Force (EITF) discussed Issue No. 02-16, "Accounting by a Reseller for Cash Consideration Received from a Vendor." Issue No. 02-16 provides guidance on the recognition of cash consideration received by a customer from a vendor. The consensus reached by the EITF in November 2002 is effective for fiscal periods beginning after December 15, 2002. Income statements for prior periods are required to be reclassified to comply with the consensus. Adoption of the consensus reached in November 2002 related to Issue No. 02-16 did not materially affect our consolidated financial statements.

In December 2002, we adopted FASB Statement No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." Statement No. 148 amends Statement No. 123, "Accounting for Stock-Based Compensation," and provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. Statement No. 148 also amends the disclosure requirements of Statement No. 123 to require more prominent and frequent disclosures in financial statements about the effects of stock-based compensation. The transition guidance and annual disclosure provisions of Statement No.148 are effective for financial statements issued for fiscal years ending after December 15, 2002. The interim disclosure provisions are effective for financial reports containing financial statements for interim periods beginning after December 15, 2002. See Note 3 for disclosure under Statement No. 148.

In January 2003, the FASB issued a pronouncement, Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities." FIN 46 deals with Off-Balance Sheet Assets, Liabilities, and Obligations and gives guidance for determining which entities should consolidate the respective assets and liabilities associated with the obligations. Corporations must fully consolidate assets and liabilities covered by FIN 46 in their financial statements in the first fiscal year or interim period beginning after December 15, 2003. Full disclosure, as

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well as consolidation, if applicable, of any newly created entities after January 31, 2003 must begin immediately. Adoption of FIN 46 is not expected to materially impact our consolidated financial statements.

In April 2003, the FASB issued Statement No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging Activities," This Statement amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts (collectively referred to as derivatives) and for hedging activities under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. This Statement is effective for contracts entered into or modified after June 30, 2003, and for hedging relationships designated after June 30, 2003. In addition, all provisions of this Statement should be applied prospectively. Adoption of FASB Statement 149 is not expected to materially impact our consolidated financial statements.

In May 2003, the FASB issued Statement No. 150, " Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. Many of those instruments were previously classified as equity. This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. Adoption of FASB Statement 150 is not expected to materially impact our consolidated financial statements.

10

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Management's Discussion and Analysis of Financial Condition and Results of Operations contains certain pro forma financial information. In all instances, management believes that use of such pro forma information is useful to investors assessing the financial condition and results of operations of our core business operations because it excludes results which management believes are atypical and unlikely to occur with regularity in the future.

The following table sets forth, for the periods indicated, the percentages which the items in our Consolidated Statements of Income bear to total revenues.

13 Weeks Ended		39 Weeks Ended	
September 28 2003	September 29 2002	September 28 2003	September 29 2002

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REVENUES	100.0%	100.0%	100.0%	100.0%
COST AND EXPENSES:				
Cost of revenues	32.8%	34.2%	32.7%	33.7%
Labor and other related expenses	33.7%	32.7%	30.7%	30.4%
Other restaurant operating expenses	28.1%	24.9%	24.4%	22.5%
	94.6%	91.8%	87.8%	86.6%
General and administrative expenses	8.9%	8.8%	7.5%	7.3%
Depreciation and amortization	2.7%	2.5%	2.3%	2.2%
Provision for impairment of goodwill	0.0%	0.5%	0.0%	0.4%
Income (loss) from operations	-6.2%	-3.6%	2.4%	3.5%
Interest expense, net	-1.1%	-1.1%	-1.0%	-1.1%
Other expense, net	-0.4%	-0.5%	-0.3%	-0.2%
Elimination of minority partner interest	-0.5%	-0.4%	-0.6%	-0.4%
Income (loss) before provision for taxes	-8.2%	-5.6%	0.5%	1.8%
Benefit from income taxes	0.0%	0.1%	0.0%	0.9%
Net income (loss)	-8.2%	-5.5%	0.5%	2.7%

11

RESULTS OF OPERATIONS

13 weeks ended September 28, 2003 and September 29, 2002

Revenues. Total revenues for the third quarter of 2003 were \$10,125,000 as compared to \$10,966,000 for the third quarter of 2002. The \$841,000, or 7.7%, decrease in revenues was primarily due to a 6.0% decrease in comparable store sales, and to a lesser extent the closing of one restaurant during the third quarter of 2002. Comparisons of same store sales include only stores that were open during the entire periods being compared and, due to the time needed for a restaurant to become established and fully operational, at least six months prior to the beginning of that period.

Cost of revenues. The cost of revenues as a percentage of revenues decreased to 32.8% for the third quarter of 2003 from 34.2% for the third quarter of 2002. This decrease primarily was due to favorable food costs and operational improvements. We continually attempt to anticipate and react to fluctuations in food costs by purchasing seafood directly from numerous suppliers, promoting certain alternative menu selections in response to price and availability of supply and adjusting our menu prices accordingly to help control the cost of revenues.

Labor and other related expenses. Labor and other related expenses as a percentage of revenues increased to 33.7% during the third quarter of 2003 as compared to 32.7% for the third quarter of 2002. This increase was primarily due to the loss of

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sales leverage in addition to increases in workers' compensation insurance.

Other restaurant operating expenses. Other restaurant operating expenses were \$2,847,000 or 28.1% of revenues for the third quarter of 2003 as compared with \$2,732,000 or 24.9% of revenues for the third quarter of 2002. The increase primarily was due to increases in restaurant maintenance costs, insurance, natural gas and electricity along with a reduction in operating leverage caused by lower sales volumes.

General and administrative expenses. General and administrative expenses of \$904,000 or 8.9% of revenues for the third quarter of 2003 increased from \$966,000 or 8.8% of revenues for the third quarter of 2002, primarily due to decreases in administrative salaries partially offset by increases in consulting fees. Excluding non-recurring severance pay of \$70,000 in the third quarter 2003, general and administrative expenses were \$834,000 or 8.2% of revenues.

Depreciation and amortization. Depreciation and amortization expense was \$276,000 or 2.7% of revenues and \$279,000 or 2.5% of revenues for the third quarters of 2003 and 2002, respectively.

Provision for impairment of goodwill. There was no provision for impairment of goodwill in the third quarter of 2003. The provision for impairment of goodwill was \$52,000 or 0.5% of revenues during the third quarter of 2002. Goodwill was evaluated for impairment and written down in accordance with FASB Statement No. 142 which we adopted in 2002.

Interest expense, net. Interest expense was \$110,000 in the third quarter of 2003 compared to \$117,000 in the third quarter of 2002. The decrease was related to the reduction of loan balances outstanding.

Benefit from income taxes. No benefit or provision for income taxes was recognized for the third quarter of 2003 based on annual projected taxable income for 2003, as adjusted for net operating loss carry forwards. A tax benefit of \$8,000 was recognized in the third quarter of 2002 relating to tax refunds.

12

Income from operations and net income. As a result of the factors discussed above, Shells had a loss from operations of \$628,000 for the third quarter of 2003 compared to a loss from operations of \$397,000 for the third quarter of 2002. Shells had a net loss of \$833,000 for the third quarter of 2003 compared to \$605,000 for the third quarter of 2002. Exclusive of a nonrecurring charge of \$70,000 relating to severance pay, the net loss was \$763,000 in the third quarter of 2003.

39 weeks ended September 28, 2003 and September 29, 2002

Revenues. Total revenues for the 39 weeks ended September 28, 2003 were \$35,038,000 as compared to \$37,603,000 for the 39 weeks ended September 29, 2002. The \$2,565,000, or 6.8%, decrease primarily was due to a reduction in same store sales of 4.6%.

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Cost of revenues. The cost of revenues as a percentage of revenues decreased to 32.7% for the 39 weeks ended September 28, 2003 from 33.7% for the comparable period in 2002. This decrease primarily related to favorable food costs and operational improvements partially offset by a non-recurring write-down of inventory of \$36,000 in 2003. Exclusive of the non-recurring item, cost of revenues was 32.6% for the 39 weeks ended September 28, 2003.

Labor and other related expenses. Labor and other related expenses increased to 30.7% as a percentage of revenues for the 39 weeks ended September 28, 2003 as compared to 30.4% for the same period in 2002. This increase was primarily attributable to the loss of sales leverage, partially offset by a 2003 non-recurring decrease in benefits and taxes relating to a reduction in the workers compensation insurance reserve (and refund) of \$197,000, of which \$182,000 was allocated to restaurant labor costs. Exclusive of the non-recurring item, labor and other related expenses was 31.2% for the 39 weeks ended September 28, 2003.

Other restaurant operating expenses. Other restaurant operating expenses were \$8,557,000 or 24.4% of revenues for the 39 weeks ended September 28, 2003 compared with \$8,447,000 or 22.5% for the same period in 2002. The increase primarily was due to a reduction in operating leverage caused by lower sales volumes and increases in restaurant maintenance costs, insurance, natural gas and electricity costs.

General and administrative expenses. General and administrative expenses increased to 7.5% as a percentage of revenues for the 39 weeks ended September 28, 2003 as compared with 7.3% for the same period in 2002. Excluding non-recurring severance pay of \$70,000 in fiscal 2003, general and administrative expenses were 7.3% of revenues for the 39 weeks ended September 28, 2003.

Depreciation and amortization. Depreciation and amortization expense was \$800,000 or 2.3% of revenues and \$834,000 or 2.2% of revenues for the 39 weeks ended September 28, 2003 and September 29, 2002, respectively.

Provision for impairment of goodwill. There was no provision for impairment of goodwill in the 39 weeks ended September 28, 2003. The provision for impairment of goodwill was \$155,000 or 0.4% of revenues during the 39 weeks ended September 29, 2002. Goodwill was evaluated for impairment and written down in accordance with FASB Statement No. 142 which we adopted in 2002.

13

Interest expense, net. Interest expense was \$347,000 in the 39 weeks ended September 28, 2003 compared to \$425,000 in the same period of 2002. This decrease related primarily to a non-recurring charge of \$106,000 in the 39 weeks ended September 29, 2002 relating to the issuance of warrants on January 31, 2002 as part of the previously reported \$2,000,000 financing transaction, partially offset by lower loan balances outstanding. Exclusive of the non-recurring charge, net interest expense was \$319,000 for the 39 weeks ended September 29, 2002.

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Benefit from income taxes. No benefit or provision for income taxes was recognized for the 39 weeks ended September 28, 2003 compared to a tax benefit of \$327,000 in the same period in 2002, relating to the applicable portion of a refund of \$1,176,000 from prior years, resulting from the Economic Stimulus Package signed into law in March 2002. The refund was received in July 2002.

Income from operations and net income. As a result of the factors discussed above, Shells income from operations was \$835,000 for the 39 weeks ended September 28, 2003 compared to \$1,327,000 for the same period in 2002. Exclusive of non-recurring items, our income from operations was \$745,000 for the 39 weeks ended September 28, 2003. Non-recurring items consisted of a benefit of \$197,000 from workers compensation reserve adjustments partially offset by an inventory write-down of \$36,000 and severance pay of \$70,000 for the 39 weeks ended September 28, 2003. The Company's net income for the 39 weeks ended September 28, 2003 was \$195,000 compared to \$980,000 in the same period in 2002. Exclusive of non-recurring items, our net income was \$105,000 for the 39 weeks ended September 28, 2003 compared to \$768,000 for the comparable period in 2002. Non-recurring items for the 39 weeks ended September 29, 2002 consisted of \$318,000 in income tax benefits, offset by \$106,000 in imputed interest expense.

LIQUIDITY AND CAPITAL RESOURCES

As of September 28, 2003, our current liabilities of \$5,105,000 exceeded our current assets of \$2,280,000, resulting in a working capital deficiency of \$2,825,000. In comparison, the December 29, 2002 working capital deficiency was \$3,116,000. The improvement in the working capital deficiency was primarily related to an increase in other assets consisting of prepaid insurance of \$269,000 coupled with reductions in accounts payable of \$481,000, accrued expenses of \$494,000, and current portion of long-term debt of \$210,000, offset in part by a reduction in cash of \$1,204,000.

Shells was negatively impacted in fiscal 2002, and to a lesser extent in fiscal 2003, by the ongoing costs of divestiture of its Midwest locations. Such divestiture costs had an adverse affect on our cash position. Historically, Shells has generally operated with minimal or negative working capital as a result of the investment of current assets into non-current property and equipment as well as the turnover of restaurant inventory relative to more favorable vendor terms in accounts payable.

Due to the seasonality of our business and depressed cash flow from operations, we are in a guarded cash position over the near term periods. Management has taken steps to improve cash flow from operations, including increased emphasis on local store marketing efforts and less reliance on expensive broadcast media, as well as our 2003 holiday season initiatives. Our holiday initiatives include a new line of party platters for off premise consumption in addition to the promotion of a new gift card program which replaces paper certificates. Cash flow requirements over the next 18 months will likely require additional financing, as the note holder debt will become due on January 31, 2005. There can be no assurance that any such financing will be available to Shells on terms acceptable to us, or at all. The failure of Shells to successfully obtain additional funding may impact

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our ability to continue our operations.

14

Cash used in operating activities for the 39 weeks ended September 28, 2003 was \$236,000 compared to cash provided by operating activities of \$218,000 for the comparable period in 2002. The net decrease of \$454,000 was primarily related to a reduction in net income, other assets and accrued expenses, partially offset by a reduction in accounts payable.

The cash used in investing activities was \$611,000 for the 39 weeks ended September 28, 2003 compared to cash provided by investing activities of \$658,000 for the comparable period in 2002. We had a net increase of \$178,000 in expenditures for capital improvements for 2003 compared to 2002. In 2002, we received proceeds from the sale of a Midwest property of \$1,091,000.

The cash used in financing activities was \$357,000 for the 39 weeks ended September 28, 2003 compared to cash provided by financing activities of \$683,000 for the comparable period in 2002. In 2002, we completed a \$2 million private financing transaction, consisting of secured promissory notes and warrants to purchase shares of our Common Stock. Also, in 2002, we repayed existing debt of \$893,000 relating to the sale of the Midwest property.

SEASONALITY

The restaurant industry in general is seasonal, depending on restaurant location and the type of food served. We experience fluctuations in our quarter-to-quarter operating results due primarily to our high concentration of restaurants in Florida. Business in Florida is influenced by seasonality due to various factors that include but are not limited to weather conditions in Florida relative to other areas of the U.S., the health of Florida's economy and the effect of world events in general and on the tourism industry in particular. Our restaurant sales are generally highest from January through April and June through August, the peaks of the Florida tourism season, and generally lower from September through mid-December. In many cases, locations are in coastal cities, where sales are significantly dependent on tourism and its seasonality patterns.

In addition, quarterly results have been, and in the future could be, affected by the timing and conditions under which restaurants are closed. Because of the seasonality of our business and the impact of restaurant closures and openings, if applicable, results for any quarter are not generally indicative of the results that may be achieved for a full fiscal year on an annualized basis and cannot be used to indicate financial performance for the entire year.

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 risk relates to the \$1,213,000 as of September 28, 2003 in

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outstanding debt with banks that is based on variable rates. Borrowings under these loan agreements bear interest at the rate equal to the applicable bank's base rate.

Item 4. Controls and Procedures

Shells maintains "disclosure controls and procedures," as such term is defined under Securities Exchange Act Rule 13a-15(e),

15

that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer/President and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures. In designing and evaluating the disclosure controls and procedures, our management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. We have carried out an evaluation, as of the end of the period covered by this report, under the supervision and with the participation of our management, including our Chief Executive Officer/President and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon their evaluation and subject to the foregoing, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective in ensuring that material information relating to Shells is made known to the Chief Executive Officer and Chief Financial Officer by others within our company during the period in which this report was being prepared.

There were no changes in our internal controls over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

16

Part II. OTHER INFORMATION

Item 1. Legal Proceedings

On May 29, 2001, a lawsuit was filed in the Court of Common Pleas of Clermont County, Ohio by Cin-Beech, LLC, the landlord of a closed restaurant located in Cincinnati. This restaurant was closed in April 2001. In July 2001, we entered into a lease termination agreement with the landlord. Pursuant to the lease termination agreement, we paid \$50,000 in termination fees and \$39,000 for rents and real estate taxes owed; and were obligated to pay an additional \$50,000 within 30 days in exchange for a simultaneous written release from the landlord. The landlord refused to provide the written release as required and,

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therefore, Shells did not pay the additional \$50,000 for which it was prepared to pay. The landlord has since demanded \$236,000, which was later reduced to \$150,000. The landlord sold the property in October 2002 to an unrelated third party. By court order, the parties reached a settlement arrangement in an August 2003 mediation whereby we will pay the landlord \$107,000 to terminate the lease and dismiss the lawsuit. We expect to finalize the settlement during the fourth quarter of 2003.

Item 2. Changes in Securities and Use of Proceeds
None

Item 3. Defaults Upon Senior Securities
None

Item 4. Submission of Matters to a Vote of Security Holders
None

Item 5. Other Information
None

17

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of Leslie J. Christon, President/Chief Executive Officer of Shells Seafood Restaurants, Inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 28, 2003.

31.2 Certification of Warren R. Nelson, Executive Vice President/Chief Financial Officer of Shells Seafood Restaurants, Inc., pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 28, 2003.

32.1 Certifications by Leslie J. Christon and Warren R. Nelson, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, in connection with Shells Seafood Restaurants, Inc.'s Quarterly Report on Form 10-Q for the quarter ended September 28, 2003.

(b) Reports on Form 8-K filed during the current quarter ended September 28, 2003.

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Shells filed a current report on Form 8-K, Item 5, regarding a press release on July 1, 2003 announcing that Leslie J. Christon joined Shells as President and Chief Executive Officer.

Shells filed a current report on Form 8-K, Item 12, regarding a press release on July 25, 2003 announcing operating results for the quarter ended June 29, 2003.

Shells filed a current report on Form 8-K, Item 5, regarding a press release on September 19, 2003 announcing that Guy C. Kathman joined Shells as Vice President of Operations.

18

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.

SHELLS SEAFOOD RESTAURANTS, INC.
(Registrant)

November 12, 2003 /s/ Leslie J. Christon
President and Chief Executive Officer
(On behalf of the registrant.)

November 12, 2003 /s/ Warren R. Nelson
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

19

SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES EXHIBIT INDEX

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31.2 Certification of Warren R. Nelson, Executive Vice

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