

LUBYS INC  
Form 10-Q  
December 22, 2009  
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**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 November 18, 2009

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 001-08308

**Luby s, Inc.**

*(Exact name of registrant as specified in its charter)*

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**Delaware**  
*(State or other jurisdiction of  
incorporation or organization)*

**74-1335253**  
*(IRS Employer  
Identification Number)*

**13111 Northwest Freeway, Suite 600**  
**Houston, Texas**  
*(Address of principal executive offices)*

**77040**  
*(Zip Code)*

**(713) 329-6800**

*(Registrant's telephone number, including area code)*

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act:

Large accelerated filer  Accelerated filer   
Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of December 10, 2009, there were 28,023,986 shares of the registrant's common stock outstanding.

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Luby's, Inc.

Form 10-Q

Quarter ended November 18, 2009

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We file reports with the Securities and Exchange Commission, including annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K. The public may read and copy any materials we file with the SEC at its Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. We are an electronic filer, and the SEC maintains an Internet site at <http://www.sec.gov> that contains the reports, proxy and information statements, and other information that we file electronically. Our website address is <http://www.lubys.com>. Please note that our website address is provided as an inactive textual reference only. We make available free of charge through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. The information provided on our website is not part of this report, and is therefore not incorporated by reference unless such information is specifically referenced elsewhere in this report.

**Table of Contents****Part I - FINANCIAL INFORMATION****Item 1. Financial Statements****Lubys, Inc.****Consolidated Balance Sheets***(In thousands, except share data)*

	November 18, 2009 <i>(Unaudited)</i>	August 26, 2009
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents	\$ 980	\$ 882
Trade accounts and other receivables, net	1,534	1,463
Food and supply inventories	3,492	2,801
Prepaid expenses	793	655
Assets related to discontinued operations	158	391
Deferred income taxes	269	192
<b>Total current assets</b>	<b>7,226</b>	<b>6,384</b>
Property and equipment, net	143,353	146,250
Long-term investments	5,080	6,903
Deferred incomes taxes	6,467	5,082
Property held for sale	3,858	3,858
Assets related to discontinued operations	24,252	25,794
Other assets	173	241
<b>Total assets</b>	<b>\$ 190,409</b>	<b>\$ 194,512</b>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Accounts payable	\$ 9,563	\$ 11,541
Liabilities related to discontinued operations	1,452	1,888
Accrued expenses and other liabilities	15,057	14,045
<b>Total current liabilities</b>	<b>26,072</b>	<b>27,474</b>
Credit facility debt	600	
Liabilities related to discontinued operations	456	382
Other liabilities	3,561	3,524
<b>Total liabilities</b>	<b>30,689</b>	<b>31,380</b>
<b>Commitments and Contingencies</b>		
<b>SHAREHOLDERS' EQUITY</b>		
Common stock, \$0.32 par value; 100,000,000 shares authorized; shares issued were 28,523,151 and 28,494,511, respectively; shares outstanding were 28,023,151 and 27,994,511, respectively	9,129	9,118
Paid-in capital	22,283	21,989
Retained earnings	133,083	136,800
Less cost of treasury stock, 500,000 shares	(4,775)	(4,775)

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Total shareholders' equity	159,720	163,132
Total liabilities and shareholders' equity	\$ 190,409	\$ 194,512

The accompanying notes are an integral part of these consolidated financial statements.

**Table of Contents****Luby's, Inc.****Consolidated Statements of Operations (unaudited)***(In thousands except per share data)*

	Quarter Ended	
	November 18, 2009 <i>(12 weeks)</i>	November 19, 2008 <i>(12 weeks)</i>
<b>SALES:</b>		
Restaurant sales	\$ 48,426	\$ 57,006
Culinary contract services	3,292	3,002
<b>TOTAL SALES</b>	<b>51,718</b>	<b>60,008</b>
<b>COSTS AND EXPENSES:</b>		
Cost of food	12,983	15,614
Payroll and related costs	18,454	20,812
Other operating expenses	11,853	13,575
Opening costs	39	61
Cost of culinary contract services	2,927	2,660
Depreciation and amortization	3,522	3,647
General and administrative expenses	5,482	6,110
Net loss (gain) on disposition of property and equipment	311	(212)
<b>Total costs and expenses</b>	<b>55,571</b>	<b>62,267</b>
<b>LOSS FROM OPERATIONS</b>	<b>(3,853)</b>	<b>(2,259)</b>
Interest income	9	119
Interest expense	(128)	(86)
Impairment charge for decrease in fair value of investments	(459)	
Other income, net	198	259
<b>Loss before income taxes and discontinued operations</b>	<b>(4,233)</b>	<b>(1,967)</b>
<b>Benefit for income taxes</b>	<b>(1,367)</b>	<b>(666)</b>
<b>Loss from continuing operations</b>	<b>(2,866)</b>	<b>(1,301)</b>
<b>Loss from discontinued operations, net of income taxes</b>	<b>(851)</b>	<b>(891)</b>
<b>NET LOSS</b>	<b>\$ (3,717)</b>	<b>\$ (2,192)</b>
<b>Loss per share from continuing operations:</b>		
Basic	\$ (0.10)	\$ (0.05)
Assuming dilution	(0.10)	(0.05)
<b>Loss per share from discontinued operations:</b>		
Basic	\$ (0.03)	\$ (0.03)
Assuming dilution	(0.03)	(0.03)
<b>Net loss per share:</b>		
Basic	\$ (0.13)	\$ (0.08)
Assuming dilution	(0.13)	(0.08)

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Weighted average shares outstanding:

Basic	28,111	28,068
Assuming dilution	28,111	28,068

The accompanying notes are an integral part of these consolidated financial statements.

Note: The Company's Cash Flow Improvement and Capital Redeployment Plan (the Plan) was approved in the first quarter of fiscal year 2010. As a result, the Company reclassified 24 stores to discontinued operations for current and prior fiscal years.

**Table of Contents****Luby s, Inc.****Consolidated Statement of Shareholders Equity (unaudited)***(In thousands)*

	Common Stock Issued		Treasury		Paid-In Capital	Retained Earnings	Total Shareholders Equity
	Shares	Amount	Shares	Amount			
BALANCE AT AUGUST 26, 2009	28,494	\$ 9,118	(500)	\$ (4,775)	\$ 21,989	\$ 136,800	\$ 163,132
Net loss						(3,717)	(3,717)
Common stock issued under nonemployee director benefit plans	12	4			59		63
Common stock issued under employee benefit plans	17	7			235		242
BALANCE AT NOVEMBER 18, 2009	28,523	\$ 9,129	(500)	\$ (4,775)	\$ 22,283	\$ 133,083	\$ 159,720

The accompanying notes are an integral part of these consolidated financial statements.



**Table of Contents****Luby's, Inc.****Consolidated Statements of Cash Flows (unaudited)***(In thousands)*

	Quarter ended	
	November 18, 2009 <i>(12 weeks)</i>	November 19, 2008 <i>(12 weeks)</i>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (3,717)	\$ (2,192)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Provision for asset impairments, net of gains and losses on property sales	(862)	(210)
Depreciation and amortization	3,799	4,365
Impairment charge for decrease in fair value of investments	459	
Amortization of debt issuance cost	67	20
Non-cash compensation expense	63	68
Share-based compensation expense	242	283
Deferred tax benefit	(1,899)	(1,264)
Cash provided by (used in) operating activities before changes in operating assets and liabilities	(1,848)	1,070
Changes in operating assets and liabilities:		
Increase in trade accounts and other receivables, net	(64)	(572)
Increase in food and supply inventories	(461)	(945)
Increase in prepaid expenses and other assets	(142)	(1,046)
(Decrease) increase in accounts payable, accrued expenses and other liabilities	(1,434)	3,146
Net cash provided by (used in) operating activities	(3,949)	1,653
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Proceeds from redemption of long-term investments	1,364	500
Proceeds from disposal of assets and property held for sale	3,016	1,111
Purchases of property and equipment	(933)	(5,477)
Net cash provided by (used in) investing activities	3,447	(3,866)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Credit facility borrowings	16,400	5,000
Credit facility repayments	(15,800)	(5,000)
Net cash provided by financing activities	600	
Net decrease in cash and cash equivalents	98	(2,213)
Cash and cash equivalents at beginning of period	882	4,566
Cash and cash equivalents at end of period	\$ 980	\$ 2,353
Cash paid for:		
Income taxes	\$	\$
Interest	34	67

The accompanying notes are an integral part of these consolidated financial statements.



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**Luby s, Inc.**

**Notes to Consolidated Financial Statements (unaudited)**

November 18, 2009

**Note 1. Basis of Presentation**

The accompanying unaudited consolidated financial statements of Luby s, Inc. (the Company or Luby s ) have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements that are prepared for the Company s Annual Report on Form 10-K. In the opinion of management, all adjustments (consisting of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the period ended November 18, 2009 are not necessarily indicative of the results that may be expected for the fiscal year ending August 25, 2010.

The balance sheet dated August 26, 2009, included in this Form 10-Q, has been derived from the audited financial statements at that date. However, this Form 10-Q does not include all of the information and footnotes required by GAAP for an annual filing of complete financial statements. Therefore, these financial statements should be read in conjunction with the consolidated financial statements and footnotes included in the Company s Annual Report on Form 10-K for the fiscal year ended August 26, 2009.

The results of operations, assets and liabilities for all units included in the disposal plan have been reclassified to discontinued operations in the statements of operations and balance sheets for all periods presented.

Events subsequent to the Company s fiscal quarter ended November 18, 2009 through the date of issuance, December 22, 2009, are evaluated to determine if the nature and significance of the event warrant inclusion in the Company s quarterly report. The Company determined there were no subsequent events warranting inclusion.

**Note 2. Accounting Periods**

The Company s fiscal year ends on the last Wednesday in August. As such, each fiscal year normally consists of 13 four-week periods, accounting for 364 days. Each of the first three quarters of each fiscal year consists of three four-week periods (12 weeks), while the fourth quarter normally consists of four four-week periods (16 weeks). Comparability between accounting periods will be affected by varying lengths of the periods, as well as the seasonality associated with the restaurant business.

**Note 3. Fair Value Measurement**

The Financial Accounting Standards Board ( FASB ) issued Accounting Standards Codification ( ASC ) Topic 820, *Fair Value Measurements* ( ASC 820 ), which defines fair value, establishes a framework for using fair value to measure assets and liabilities, and expands disclosure about fair value measurements. ASC 820 applies whenever other statements require or permit asset or liabilities to be measured at fair value. The Company adopted the provisions of ASC 820 at the beginning of the first quarter of fiscal year 2009.

ASC 820 establishes a three-tier fair value hierarchy, which prioritizes the inputs used to measure fair value. These tiers include:

Level 1: Defined as observable inputs such as quoted prices in active markets for identical assets or liabilities as of the reporting date. Active markets are those in which transactions for the asset or liability occur in sufficient frequency and volume to provide pricing information on an ongoing basis.

Level 2: Defined as pricing inputs other than quoted prices in active markets included in Level 1, which are either directly or indirectly observable as of the reporting date. Level 2 includes those financial instruments that are valued using models or other valuation methodologies. These models are primarily industry-standard models that consider various assumptions, including quoted forward prices for commodities, time value, volatility factors, and current market and contractual prices for the underlying instruments, as well as other relevant economic measures.

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Level 3: Defined as pricing inputs that are unobservable from objective sources. These inputs may be used with internally developed methodologies that result in management's best estimate of fair value.

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As of November 18, 2009, the Company held auction rate securities, which are classified as available-for-sale investments under long-term investments on the balance sheet and are required to be measured at fair value on a recurring basis. As discussed in Note 4 below, the continued illiquidity in the auction rate market has affected the fair market value of the Company's auction rate securities because the auctions continue to fail. Therefore, in the absence of an active market, the Company estimated the fair value of these investments using price submissions from traders specializing in the securities. These traders considered, among other things, the collateralization underlying the security, the creditworthiness of the counterparty, the timing of the expected future cash flows, the interest rate of the Company's investments compared to similar investments, the current illiquidity of the investments, and the estimated next successful auction of the security.

Management believes the Company will more likely than not sell its auction rate securities prior to maturity or prior to the time when the securities can be sold for par value. The market for the Company's auction rate securities has not been liquid for an extended time and the credit risk of the security issuers and related insurers is uncertain. Therefore, the Company considers the impairment of its auction rate securities to be other-than-temporary.

As a result of the other-than-temporary decline in the fair value of the Company's auction rate securities investments, the Company recorded a realized holding loss of approximately \$0.5 million during the quarter ended November 18, 2009 and zero during the quarter ended November 19, 2008. Any recoveries of previous recognized losses will not be recognized until the security is sold. Any future decrease in fair value related to these investments will increase the Company's recognized loss in these securities.

The assets measured at fair value on a recurring basis were as follows:

	Fair Value Measurement at November 18, 2009 Using		
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2) <i>(In thousands)</i>	Significant Unobservable Inputs (Level 3)
Balance at August 27, 2008	\$	\$	\$ 8,525
Purchase of long-term investments			
Sale of long-term investments			(625)
Total gains or losses (realized and unrealized):			
Included in net income (loss)			(997)
Balance at August 26, 2009			6,903
Purchase of long-term investments			
Sale of long-term investments			(1,364)
Total gains or losses (realized and unrealized):			
Included in net income (loss)			(459)
Balance at November 18, 2009	\$	\$	\$ 5,080

The carrying value of cash and cash equivalents, trade accounts and other receivable, accounts payable and accrued expenses approximate fair value based on the short term nature of these accounts. The carrying value of credit facility debt approximates fair value based on the recent renegotiated terms of our credit facility.

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Investments include available-for-sale securities which are reported at fair value with unrealized gains and losses excluded from earnings and reported in shareholders' equity unless such losses are considered other-than-temporary. The Company recorded \$7.2 million par value (\$5.1 million fair value) and \$8.7 million par value (\$6.9 million fair value) as of November 18, 2009 and August 26, 2009, respectively, in auction rate municipal bonds as long-term investments. Adjustments to fair value were recorded in fiscal years 2008 and 2009 and the first quarter of fiscal year 2010 based on the continued illiquidity of the auction rate securities market and a valuation of the securities. The Company recognized cumulative unrealized losses of \$2.1 million and \$1.8 million losses as of November 18, 2009 and August 26, 2009, respectively, including a \$0.5 million loss recognized in the quarter ended November 18, 2009, which were considered other-than-temporary and are recorded as a charge to earnings.

Currently, there are no active markets for the Company's auction rate securities. Therefore, the Company estimated the fair value using valuation models and methodologies. Based on these valuation models and methodologies and on the possible long-term illiquidity of the markets, the Company recognized an other-than-temporary impairment. See Note 3, Fair Value Measurement, above.

The auction rate municipal securities are long-term debt obligations that are secured by certain revenue streams (airport, sewer, hospital, etc.). These auction rate securities have insurance policies guaranteeing, with respect to each bond, the payment of principal and accrued interest, as scheduled, if the issuer is unable to service the debt and have been issued ratings ranging from A1 Aaa (Moody's) and AA AAA (Standard and Poor's). The bonds have experienced this disparity in credit ratings because of the insurance company's revised credit ratings issued by Moody's and Standard and Poor's. If these securities continue to fail at auction, interest income will continue to accrue at a designated benchmark rate plus a premium; otherwise, they will be sold. At each of the resets between February 12, 2008 and November 18, 2009, the Company received all accrued interest due.

When normal trading on the auction rate securities market halted in February 2008, the Company had sell orders on all of its holdings. The Company received par and book value of \$0.625 million plus accrued interest on the bonds in fiscal year 2009. During the first quarter ended November 18, 2009, the Company sold one auction rate municipal bond with a par value of \$1.6 million (\$1.3 million book value) at a 12% discount and received \$1.4 million including accrued interest.

These municipal bonds have underlying maturity dates ranging from June 1, 2019 through February 1, 2042 offering rates tied to benchmarks plus a premium. Historically, the auction process allowed investors to obtain immediate liquidity by selling the securities at their face amounts. Liquidity for these securities was historically provided by entering sales orders through a Dutch-auction process that resets interest rates on these investments every 7, 28 or 35 days. However, the disruptions in the credit markets have continued to adversely affect the auction market for these types of securities.

**Note 5. Income Taxes**

For the quarter ended November 18, 2009, including both continuing and discontinued operations, the Company generated a gross taxable loss of approximately \$4.3 million. No cash payments of estimated income taxes were made during the quarter ended November 18, 2009.

Deferred tax assets and liabilities are recorded based on differences between the financial reporting basis and the tax basis of assets and liabilities using currently enacted rates and laws that will be in effect when the differences are expected to reverse. Deferred tax assets are recognized to the extent future taxable income is expected to be sufficient to utilize those assets prior to their expiration. If current available information raises doubt about the realization of the deferred tax assets, a valuation allowance would be necessary. A valuation allowance for deferred tax assets may be required if recovery of prior taxes by carrying back current losses to prior years is not available, if the Company projects lower levels of future taxable income, or if the Company recently experienced consecutive pretax losses. Such a valuation allowance would be established through a charge to income tax expense which would adversely affect the Company's reported operating results. Management concluded that for the quarter ended November 18, 2009 an increase in the valuation allowance of approximately \$69,000 was necessary. The valuation allowance partially offsets the Company's operating loss (NOL) carryovers to future years and its carryover of general business tax credits.

Management believes that adequate provisions for income taxes have been reflected in the financial statements and is not aware of any significant exposure items that have not been reflected in the financial statements. Amounts considered probable of settlement within one year have been included in the accrued expenses and other liabilities in the accompanying consolidated balance sheet. The Company does not anticipate any material change in the total amount of unrecognized tax benefits to occur within the next thirteen four-week periods.



**Table of Contents****Note 6. Property and Equipment**

The cost and accumulated depreciation of property and equipment at November 18, 2009 and August 26, 2009, together with the related estimated useful lives used in computing depreciation and amortization, were as follows:

	November 18, 2009	August 26, 2009	Estimated Useful Lives
	<i>(In thousands)</i>		
Land	\$ 40,540	\$ 40,540	
Restaurant equipment and furnishings	92,254	92,153	3 to 15 years
Buildings	148,108	148,003	20 to 33 years
Leasehold and leasehold improvements	22,844	22,722	Lesser of lease term or estimated useful life
Office furniture and equipment	6,292	6,280	3 to 10 years
Construction in progress	473	544	
	310,511	310,242	
Less accumulated depreciation and amortization	(167,158)	(163,992)	
Property and equipment, net	\$ 143,353	\$ 146,250	

**Note 7. Impairment of Long-Lived Assets, Discontinued Operations and Property Held for Sale*****Impairment of Long-Lived Assets and Store Closings***

The Company periodically evaluates long-lived assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company estimates future cash flows expected to result from the use and possible disposition of the asset and will recognize an impairment loss when the sum of the undiscounted estimated future cash flows is less than the carrying amounts of such assets. The estimates of future cash flows, based on reasonable and supportable assumptions and projections, require management's subjective judgments. The span of time for which future cash flows are estimated is often lengthy, which increases the sensitivity to assumptions made. Depending on the assumptions and estimates used, the estimated future cash flows projected in the evaluation of long-lived assets can vary within a wide range of outcomes. The Company considers the likelihood of possible outcomes in determining the best estimate of future cash flows. The measurement for such an impairment loss is then based on the fair value of the asset as determined by either discounted cash flows, appraisals or the estimated net proceeds upon sale. With respect to continuing operations, write-downs associated with these impairment analyses, as well as actual exit costs incurred for store closings are reflected in the Consolidated Statements of Operations in Provision for asset impairments, net.

***Discontinued Operations***

As a result of the first quarter fiscal year 2010 adoption of the Company's Cash Flow Improvement and Capital Redeployment Plan (the Plan), the Company reclassified 24 operating stores to discontinued operations. The results of operations, assets and liabilities for all units included in the disposal plan have been reclassified to discontinued operations in the statement of operations and balance sheets for all periods presented.

The following table sets forth the sales and pretax losses reported for all discontinued locations:

	Quarter ended	
	November 18, 2009 <i>(12 weeks)</i>	November 19, 2008 <i>(12 weeks)</i>



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*(In thousands, except discontinued locations  
and per share data)*

Sales	\$	3,747	\$	8,939
Pretax losses		(1,285)		(1,360)
Income tax benefit on discontinued operations		434		469
Net loss on discontinued operations		(851)		(891)
Effect on EPS from pretax losses:				
Basic		(0.05)		(0.05)
Discontinued locations closed during the period		23		

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When the Company formally settles lease terminations or reaches definitive agreements to terminate leases in communication with the Plan, the related charges will be recorded. For the periods presented, no lease exit costs associated with the business plan met these criteria and are not accrued as of that date. Furthermore, the Company did not accrue future rental costs in instances where locations closed; since management has the ability to sublease at amounts equal to or greater than the rental costs. The Company incurred \$0.7 million and zero in employee settlement costs in the quarters ended November 18, 2009 and November 19, 2008, respectively.

The following table summarizes discontinued operations for the periods presented:

	Quarter ended	
	November 18, 2009 (12 weeks) (In thousands, except per share data)	November 19, 2008 (12 weeks) (In thousands, except per share data)
Impairments	\$	\$
Gains (Losses)	1,172	(2)
Net impairments	1,172	(2)
Other	(2,023)	(889)
Discontinued operations	(851)	(891)
Effect on EPS from net impairments - decrease - basic	\$ 0.04	\$
Effect on EPS from discontinued operations - decrease - basic	\$ (0.03)	\$ (0.03)

Within discontinued operations, the Company offsets gains from applicable property disposals against total impairments. The amounts in the table described as *Other* include employment termination and shut-down costs, as well as operating losses through each restaurant's closing date and carrying costs until the locations are finally disposed.

The impairment charges included above relate to properties closed and designated for immediate disposal. The assets of these individual operating units have been written down to their net realizable values. In turn, the related properties have either been sold or are being actively marketed for sale. All dispositions are expected to be completed within one to three years. Within discontinued operations, the Company also recorded the related fiscal year-to-date net operating results, employee terminations and basic carrying costs of the closed units.

**Property Held for Sale**

Property held for sale includes unimproved land, closed restaurant properties and related equipment for locations not classified as discontinued operations. The specific assets are valued at the lower of net depreciable value or net realizable value.

At August 26, 2009, the Company had a total of four owned properties and four ground leases recorded at approximately \$3.9 million in property held for sale.

As discussed above under *Discontinued Operations*, in the first quarter of fiscal year 2010, the Company adopted the Plan, which included closing 23 underperforming stores. The closed stores consisted of 21 owned properties and two in-line leases in strip malls that the Company will attempt to sublease or settle. In addition, the Company decided to market for sale three unimproved properties, two of which are ground leases and one which is owned. The Plan assets also include a ground lease location that was closed in fiscal year 2009 and not previously in property held for sale.

In conjunction with the Plan adoption, the Company recorded in the fourth quarter of fiscal year 2009 a non-cash, pre-tax \$19.0 million impairment charge. Of the total impairment charge, \$13.1 million related to the newly closed locations, \$4.4 million related to stores that have not been closed, \$0.9 million related to stores previously closed, and \$0.6 million related to unimproved properties that will be sold.

During the first quarter of fiscal year 2010, two of the recently closed stores were sold.

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As of November 18, 2009, the Company had 24 owned properties held for sale with a carrying value of approximately \$3.9 million as properties held for sale and \$23.0 million included in assets related to discontinued operations in the consolidated balance sheet. There are a total of seven ground leases for sale; five include restaurant buildings and two do not. All of the ground leased assets have zero carrying value on the Company's balance sheet. The two in-line leased properties also have a carrying value of zero. The Company is actively marketing the locations currently classified as property held for sale.

The Company's results of discontinued operations will be affected by the disposal of properties held for sale to the extent proceeds from the sales exceed or are less than net book value.

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### **Note 8. Commitments and Contingencies**

#### ***Off-Balance Sheet Arrangements***

The Company has no off-balance sheet arrangements.

#### ***Pending Claims***

Certain current and former hourly restaurant employees filed a lawsuit against the Company in the U.S. District Court for the Southern District of Texas alleging violations of the Fair Labor Standards Act with respect to the inclusion of certain employees in a tip pool. The lawsuit seeks penalties and attorney's fees and was conditionally certified as a collective action in October 2008. The Company intends to vigorously defend its position. It is not possible at this time to reasonably estimate the possible loss or range of loss, if any.

From time to time, the Company is subject to various other private lawsuits, administrative proceedings and claims that arise in the ordinary course of its business. A number of these lawsuits, proceedings and claims may exist at any given time. These matters typically involve claims from guests, employees and others related to issues common to the restaurant industry. The Company currently believes that the final disposition of these types of lawsuits, proceedings and claims will not have a material adverse effect on its financial position, results of operations or liquidity. It is possible, however, that the Company's future results of operations for a particular quarter or fiscal year could be impacted by changes in circumstances relating to lawsuits, proceedings or claims.

#### ***Construction Activity***

From time to time, the Company enters into non-cancelable contracts for the construction of its new restaurants. This construction activity exposes the Company to the risks inherent in new construction including but not limited to rising material prices, labor shortages, delays in getting required permits and inspections, adverse weather conditions, and injuries sustained by workers. The Company has no non-cancelable contracts as of November 18, 2009.

### **Note 9. Related Parties**

#### ***Affiliate Services***

The Company's Chief Executive Officer, Christopher J. Pappas, and Chief Operating Officer, Harris J. Pappas, own two restaurant entities (the Pappas entities) that may provide services to the Company and its subsidiaries, as detailed in the Master Sales Agreement dated December 9, 2005 among the Company and the Pappas entities.

Under the terms of the Master Sales Agreement, the Pappas entities may provide specialized (customized) equipment fabrication and basic equipment maintenance, including stainless steel stoves, shelving, rolling carts, and chef tables. The total costs under the Master Sales Agreement of custom-fabricated and refurbished equipment in the quarters ended November 18, 2009 and November 19, 2008 were \$26,000 and \$150,000, respectively. Services provided under this agreement are subject to review and approval by the Finance and Audit Committee.

#### ***Operating Leases***

The Company previously leased from the Pappas entities property that was used to accommodate the Company's in-house repair and fabrication center, which was referred to as the Houston Service Center. The Company terminated this lease in August 2008. The Company paid zero dollars pursuant to the terms of this lease in the quarters ended November 18, 2009 and November 19, 2008. The Company leases from an unrelated third party a new property that combines both the offices of the Company's Facility Services and Warehouse Operations. The property is approximately 60,000 square feet.

The Company also previously leased from the Pappas entities approximately 27,000 square feet of warehouse space to complement the Houston Service Center at a monthly rate of approximately \$0.21 per square foot. The Company paid zero dollars pursuant to the terms of this lease in the quarters ended November 18, 2009 and November 19, 2008. On February 29, 2008, the Company terminated this lease.

In the third quarter of fiscal year 2004, Messrs. Pappas became partners in a limited partnership which purchased a retail strip center in Houston, Texas. Messrs. Pappas collectively own a 50% limited partnership interest and a 50% general partnership interest in the limited partnership. A third party company manages the center. One of the Company's restaurants has rented approximately 7% of the space in that center since July

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1969. No changes were made to the Company's lease terms as a result of the transfer of ownership of the center to the new partnership. The Company made payments of \$57,000 and \$46,300 in the quarter ended November 18, 2009 and November 19, 2008, respectively, under the lease agreement that currently includes an annual base rate of \$14.64 per square foot.

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On November 22, 2006, the Company executed a new lease agreement with respect to this shopping center. Effective upon the Company's relocation and occupancy into the new space in July 2008, the new lease agreement provides for a primary term of approximately twelve years with two subsequent five-year options and gives the landlord an option to buy out the tenant on or after the calendar year 2015 by paying the then unamortized cost of improvements to the tenant. The Company owed, under the lease, \$16.65 per square foot plus maintenance, taxes, and insurance for the calendar year 2008. For calendar year 2009 the Company will pay \$20.00 per square foot plus maintenance, taxes and insurance. Thereafter, the lease provides for reasonable increases in rent at set intervals. The new lease agreement was approved by the Finance and Audit Committee.

Affiliated rents paid for the Houston Service Center, the separate storage facility and the Houston property leases combined represented 5.4% and 4.0% of total rents for continuing operations for the quarter ended November 18, 2009 and November 19, 2008, respectively.

	Quarter ended	
	November 18, 2009 (12 weeks) (In thousands, except percentages)	November 19, 2008 (12 weeks)
<b>AFFILIATED COSTS INCURRED:</b>		
General and administrative expenses – professional and other costs	\$ 13	\$ 50
Capital expenditures – custom-fabricated and refurbished equipment and furnishings	26	150
Other operating expenses and opening costs, including property leases	57	50
<b>Total</b>	<b>\$ 96</b>	<b>\$ 250</b>
<b>RELATIVE TOTAL COMPANY COSTS:</b>		
General and administrative expenses	\$ 5,482	\$ 6,110
Capital expenditures	868	4,742
Other operating expenses and opening costs	11,892	13,636
<b>Total</b>	<b>\$ 18,242</b>	<b>\$ 24,488</b>
<b>AFFILIATED COSTS INCURRED AS A PERCENTAGE OF RELATIVE TOTAL COMPANY COSTS</b>	<b>0.53%</b>	<b>1.02%</b>

**Board of Directors**

Pursuant to the terms of a separate Purchase Agreement dated March 9, 2001, entered into by and among the Company, Christopher J. Pappas and Harris J. Pappas, the Company agreed to submit three persons designated by Christopher J. Pappas and Harris J. Pappas as nominees for election at the 2002 Annual Meeting of Shareholders. Messrs. Pappas designated themselves and Frank Markantonis as their nominees for directors, all of whom were subsequently elected. Christopher J. Pappas and Harris J. Pappas are brothers. Frank Markantonis is an attorney whose principal client is Pappas Restaurants, Inc., an entity owned by Harris J. Pappas and Christopher J. Pappas.

As amended in June 2004, the Purchase Agreement allows Messrs. Pappas to continue to nominate persons for election to the board, which, if such nominees are elected, would result in Messrs. Pappas having nominated three of the then-serving directors of the Company. Messrs. Pappas retain their right for so long as they both are executive officers of the Company.

Christopher J. Pappas is a member of the advisory board of Amegy Bank, National Association, which is a lender and syndication agent under the Company's 2009 amended and restated revolving credit facility ( New Credit Facility ).

**Key Management Personnel**

In November 2005, Christopher and Harris Pappas entered into new employment agreements that were subsequently amended in November 2008 to extend the termination date thereof to August 2010. Both continue to devote their primary time and business efforts to the Company while maintaining their roles at Pappas Restaurants, Inc.

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On April 20, 2009, the Board of Directors of the Company approved the renewal of a consultant agreement with Ernest Pekmezaris, the Company's former Chief Financial Officer. Under the agreement, Mr. Pekmezaris will continue to furnish to the Company advisory and consulting services related to finance and accounting matters and other related consulting services. The agreement expires on January 31, 2010. Mr. Pekmezaris is also the Treasurer of Pappas Restaurants, Inc. Compensation for the services provided by Mr. Pekmezaris to Pappas Restaurants, Inc. is paid entirely by that entity.

Peter Tropoli, Senior Vice President, Administration, General Counsel and Secretary of the Company, is an attorney who, in the past, has provided litigation services to entities controlled by Christopher J. Pappas and Harris J. Pappas. Mr. Tropoli is the stepson of Frank Markantonis, who is a director of the Company.

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Paulette Gerukos, Vice President of Human Resources of the Company, is the sister-in-law of Harris J. Pappas, the Chief Operating Officer.

**Note 10. Share-Based Compensation****Stock Options**

The Company has an Incentive Stock Plan for officers and employees together ( Employee Stock Plans ) and a Non-employee Director Stock Option Plan for non-employee directors. These plans authorize the granting of stock options, restricted stock and other types of awards consistent with the purpose of the plans. Approximately 2.8 million shares are authorized for issuance under the Company's plans as of November 18, 2009, of which approximately 1.3 million shares are available for future issuance. Stock options granted under the Incentive Stock Plan and the Non-employee Director Stock Option Plan have an exercise price equal to the market price of the Company's common stock at the date of grant. Option awards under the Employee Stock Plans generally vest 25% each year on the anniversary of the grant date and expire six to ten years from the grant date. Option awards under the Non-employee Director Stock Option Plan generally vest 100% on the first anniversary of the grant date and expire ten years from the grant date.

A summary of the Company's stock option activity for the quarter ended November 18, 2009 is presented below:

	Shares Under Fixed Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value (In thousands)
Outstanding at August 26, 2009	1,025,451	\$ 8.77	4.58	\$ 43
Granted				
Exercised				
Forfeited or Expired				
Outstanding at November 18, 2009	1,025,451	8.77	4.35	
Exercisable at November 18, 2009	551,657	\$ 10.68	2.74	\$ 24

**Restricted Stock**

Restricted stock grants consist of the Company's common stock and generally vest after three years, with the exception of grants under the Nonemployee Director Stock Option Plan, which vest when granted because they are granted in lieu of a cash payment. All restricted stock grants are cliff-vested. Restricted stock awards are valued at the average market price of the Company's common stock at the date of grant.

A summary of the Company's restricted stock activity during the quarter ended November 18, 2009 is presented in the following table:

	Restricted Stock Units	Weighted-Average Fair Value (Per share)	Weighted-Average Remaining Contractual Term (Years)
Unvested at August 26, 2009	80,155	\$ 9.62	1.06
Granted			
Vested	20,969	10.28	
Forfeited	10	10.28	
Unvested at November 18, 2009	59,176	\$ 9.37	1.15



**Note 11. Earnings Per Share**

Basic net income per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the reporting period. Diluted net income per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted net income per share, the basic weighted average number of shares is increased by the dilutive effect of stock options determined using the treasury stock method. Stock options with exercise prices exceeding current market prices that were excluded from the computation of net income per share amounted to approximately 1,010,000 shares and 653,000 shares for the quarter ended November 18, 2009 and November 19, 2008, respectively.

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The components of basic and diluted net income per share are as follows: