SHELLS SEAFOOD RESTAURANTS INC
Form 10-Q
August 11, 2004

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 June 27, 2004

__ 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. 0-28258

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

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

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 x No ____

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes [ ] No [X]

Class	Outstanding at July 29, 2004
Common stock, $0.01 par value	4,812,740

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SHELLS SEAFOOD RESTAURANTS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS

	(Unaudited) June 27, 2004	December 28, 2003
ASSETS		
Cash	$ 1,053,119	$ 723,939
Inventories	402,777	382,549
Other current assets	607,271	265,891
Receivables from related parties	87,599	110,147
Total current assets	2,150,766	1,482,526
Property and equipment, net	6,679,567	6,996,095
Other assets	620,805	663,189
Goodwill	2,474,407	2,474,407
TOTAL ASSETS	$ 11,925,545	$ 11,616,217
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 1,807,706	$ 2,390,685
Accrued expenses	2,352,825	2,295,290
Sales tax payable	197,998	168,385
Notes and deferred interest payable to related parties (Note 4)	2,182,536	-
Current portion of long-term debt	273,979	234,247
Total current liabilities	6,815,044	5,088,607
Deferred rent	895,154	1,053,531
Long-term debt, less current portion	1,639,991	1,558,245

Notes and deferred interest payable to related parties (Note 4)	-	2,267,416
Total liabilities	9,350,189	9,967,799
Minority partner interest	473,173	465,836
STOCKHOLDERS' EQUITY:		
Preferred stock, $0.01 par value; authorized 2,000,000 shares; 35,275 and 63,548 shares issued and outstanding, respectively	353	635
Common stock, $.01 par value; authorized 20,000,000 shares; 4,812,740 and 4,631,375 shares issued and outstanding, respectively	48,128	46,314
Additional paid-in-capital	14,318,419	14,303,151
Accumulated deficit	(12,264,717)	(13,167,518)
Total stockholders' equity	2,102,183	1,182,582
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 11,925,545	$ 11,616,217

See accompanying notes to consolidated financial statements.

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

	13 Weeks Ended	
	June 27, 2004	June 29, 2003
REVENUES	$ 10,996,898	$ 11,901,337
COST AND EXPENSES:		
Cost of revenues	3,730,111	3,926,727
Labor and other related expenses	3,249,954	3,496,061
Other restaurant operating expenses	2,509,812	2,880,211
General and administrative expenses	866,163	874,015
Depreciation and amortization	282,593	263,293
	10,638,633	11,440,307
INCOME FROM OPERATIONS	358,265	461,030
OTHER INCOME (EXPENSE):		
Interest expense	(104,926)	(118,843)

Interest income	889	3,531
Other income (expense), net	74,645	(31,585)
	(29,392)	(146,897)
INCOME BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	328,873	314,133
ELIMINATION OF MINORITY PARTNER INTEREST	(70,722)	(69,953)
INCOME BEFORE PROVISION FOR INCOME TAXES	258,151	244,180
PROVISION FOR INCOME TAXES	-	-
NET INCOME	$ 258,151	$ 244,180
NET INCOME PER SHARE OF COMMON STOCK:		
Basic	$ 0.05	$ 0.05
Diluted	$ 0.02	$ 0.02
AVERAGE WEIGHTED NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,720,756	4,561,797
Diluted	10,445,374	11,466,292

See accompanying notes to consolidated financial statements.

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

	26 Weeks Ended	
	June 27, 2004	June 29, 2003
REVENUES	$ 23,588,270	$ 24,913,322
COST AND EXPENSES:		
Cost of revenues	7,840,779	8,149,567
Labor and other related expenses	6,997,919	7,352,669
Other restaurant operating expenses	5,321,266	5,709,736
General and administrative expenses	1,659,557	1,713,754
Depreciation and amortization	578,786	524,086
	22,398,307	23,449,812
INCOME FROM OPERATIONS	1,189,963	1,463,510

OTHER INCOME (EXPENSE):		
Interest expense	(207,124)	(245,665)
Interest income	2,194	8,145
Other income (expense), net	57,320	(53,370)
	(147,610)	(290,890)
INCOME BEFORE ELIMINATION OF MINORITY PARTNER INTEREST AND INCOME TAXES	1,042,353	1,172,620
ELIMINATION OF MINORITY PARTNER INTEREST	(139,522)	(144,357)
INCOME BEFORE PROVISION FOR INCOME TAXES	902,801	1,028,263
PROVISION FOR INCOME TAXES	-	-
NET INCOME	$ 902,801	$ 1,028,263
NET INCOME PER SHARE OF COMMON STOCK:		
Basic	$ 0.19	$ 0.23
Diluted	$ 0.09	$ 0.09
AVERAGE WEIGHTED NUMBER OF COMMON SHARES OUTSTANDING:		
Basic	4,677,384	4,507,906
Diluted	10,618,336	11,413,529

See accompanying notes to consolidated financial statements.

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

	26 Weeks Ended	
	June 27, 2004	June 29, 2003
OPERATING ACTIVITIES:		
Net income	$ 902,801	$ 1,028,263
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	578,786	524,086
(Gain) loss on sale of assets	(89,161)	2,352
Loss on sale of assets applied against reserves	24,776	-
Minority partner interest	7,337	31,647
Changes in current assets and		

liabilities	(658,456)	(1,429,249)
Decrease in other assets	18,798	22,442
Changes in other liabilities:		
Decrease in income taxes payable	-	(3,300)
Increase in accrued interest to related parties	-	70,998
Decrease in deferred rent	(49,489)	(21,391)
Total adjustments	(167,414)	(802,415)
Net cash provided by operating activities	735,392	225,848
INVESTING ACTIVITIES:		
Proceeds from sale of assets	88,776	-
Purchase of property and equipment	(467,951)	(393,180)
Net cash used in investing activities	(379,175)	(393,180)
FINANCING ACTIVITIES:		
Proceeds from debt financing	162,298	578,585
Repayment of debt	(206,135)	(626,616)
Proceeds from the issuance of stock	16,800	-
Net cash used in financing activities	(27,037)	(48,031)
Net increase (decrease) in cash	329,180	(215,363)
CASH AT BEGINNING OF PERIOD	723,939	2,468,809
CASH AT END OF PERIOD	$ 1,053,119	$ 2,253,446

See accompanying notes to consolidated financial statements.

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

	26 Weeks Ended	
	June 27, 2004	June 29, 2003
Cash flows (outflows) from changes in current assets and liabilities:		
Inventories	$ (20,228)	$ (40,810)
Receivables from related parties	22,548	975
Other current assets	(341,381)	(675,429)
Accounts payable	(582,979)	(460,098)
Accrued expenses	153,535	(299,950)
Sales tax payable	29,613	46,063
Increase in accrued interest to		

related parties	80,435	-
Change in current assets and liabilities	$ (658,456)	$ (1,429,249)
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 122,336	$ 179,964

Non-cash operating and investing activities:

Accrued interest to related parties of $165,315 was refinanced through a second mortgage in June 2004 and classified as long-term debt.
Insurance reserves of $96,000 have been applied to asset impairment charges in June 2004.
Loss on sale of assets applied against reserves of $24,776 reduced net book value of property and equipment by $19,062 and deferred rent by $5,714 in June 2004.
Deferred rent of $114,602 was applied to gain in sale of restaurant in April 2004.
Asset impairment charges of $110,000 were applied against gain on sale of restaurant in April 2004.
Bonuses of $64,315 were paid in common stock during the second quarter of 2003.

See accompanying notes to consolidated financial statements.

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

	PREFERRED STOCK Shares	PREFERRED STOCK Amount	COMMON STOCK Shares	COMMON STOCK Amount	ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS (DEFICIT)
Balance at December 28, 2003	63,548	$ 635	4,631,375	$ 46,314	$14,303,151	$(13,167,51
Net income						902,80
Preferred stock converted to common stock	(28,273)	(282)	141,365	1,414	(1,132)	
Stock options converted to common stock			40,000	400	16,400	
Balance at June 27, 2004	35,275	$ 353	4,812,740	$ 48,128	$14,318,419	$(12,264,7

See accompanying notes to consolidated financial statements.

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. (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 28, 2003 filed with the 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":

13 Weeks Ended	June 27, 2004	June 29, 2003
Net income applicable to common stock	$ 258,151	$ 244,180
Weighted common shares outstanding	4,720,756	4,561,797
Basic net income per share of common stock	$ 0.05	$ 0.05
Effect of dilutive securities:		
Warrants	5,690,683	6,450,642
Stock options	33,935	453,853
Diluted weighted common shares outstanding	10,445,374	11,466,292
Diluted net income per share of common stock	$ 0.02	$ 0.02

26 Weeks Ended	June 27, 2004	June 29, 2003
Net income applicable to common stock	$ 902,801	$ 1,028,263

Weighted common shares outstanding	4,677,384	4,507,906
Basic net income per share of common stock	$ 0.19	$ 0.23
Effect of dilutive securities:		
Warrants	5,875,509	6,450,642
Stock options	65,443	454,981
Diluted weighted common shares outstanding	10,618,336	11,413,529
Diluted net income per share of common stock	$ 0.09	$ 0.09

The earnings per share calculations excluded warrants and options to purchase an aggregate of 781,583 and 545,588 shares of common stock during the 13 weeks ended June 27, 2004 and June 29, 2003, respectively, and warrants and options to purchase an aggregate of 621,177 and 541,172 shares of common stock during the 26 weeks ended June 27, 2004 and June 29, 2003, respectively, as the exercise price of the warrants and options were greater than the average market price of the common shares.

NOTE 3. STOCK COMPENSATION PLANS

At June 27, 2004, 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 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. SUBSEQUENT EVENT

On August 4, 2004, our $2,000,000 aggregate principal amount of secured promissory notes set to mature on January 31, 2005 were extended to be due on January 31, 2007, under the same terms as the original notes. As an inducement to extend the maturity date of the notes, warrants to purchase 2,000,000 shares of Common Stock at an exercise price of $0.50 per share were issued to the note holders in proportion to the value of their respective notes. These newly issued warrants are exercisable from January 31, 2005 through January 31, 2007. The Company recognized a one-time, non-cash charge of $446,000 relating to this transaction.

NOTE 5. NEW ACCOUNTING PRONOUNCEMENTS

In January 2003, the FASB issued a pronouncement, Financial Interpretation Number 46 ("FIN 46"), "Consolidation of Variable Interest Entities." This FIN 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 June 15, 2003. Full disclosure, as well as consolidation, if applicable, of any newly created agreements after January 31, 2003 must begin immediately. Adoption of FIN 46 did not 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 did not 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 No. 150 did not materially impact our consolidated financial statements.

In December 2003, the FASB revised Statement No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits" which amended FASB Statements No. 87, 88, and 106. Statement No. 132 requires additional disclosures about the assets, obligations, cash flows, and net periodic benefit cost of defined benefit pension plans and other defined benefit post-retirement plans. The required information should be provided separately for pension plans and for other post-retirement benefit plans. Adoption of revised FASB Statement No. 132 did not materially impact our consolidated financial statements.

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

GENERAL

During the second quarter of Fiscal 2004, we continued to take significant steps aimed at updating the Shells concept and elevating our customer service and restaurant-level execution. We revamped our management and hourly training programs, and began retraining and certifying our employees to drive service improvements. We continued to refine the new menu which was rolled out during the first quarter of fiscal 2004. The success of our new recruiting program helped increase the caliber of our restaurant manager candidates. We also introduced a new beverage program during the second quarter, resulting in increased beverage alcohol sales.

The various improvements have been well received by customers, as measured by our guest satisfaction survey system. Customer ratings for service, food quality and cleanliness all improved during the second quarter of fiscal 2004.

Sales trends continued to lag prior year levels as same store sales declined 4.2% from the second quarter of 2003. We believe sales trends continue to reflect customer perceptions of our restaurants' physical environment, which we are working to update and enhance. We have developed a new color, lighting and decor package which gives our restaurants a much brighter and more contemporary atmosphere. During the quarter, we completed the remodeling of our West Palm Beach restaurant with the new design and held a grand reopening event in May. Since remodeling, this restaurant has achieved increases in sales and customer traffic relative to comparable chain-wide performance. During July, we completed remodeling of a second restaurant, in Redington Shores, marking the first restaurant in the Tampa area to feature Shells' new look.

We believe that the ongoing enhancements to the Shells concept, coupled with operational performance improvements, will provide a more compelling dining experience. Our marketing is focused on attracting new customers to experience these changes. During the quarter, we initiated a marketing promotion of new menu offerings supported by television and radio in select markets, and point of purchase materials in all restaurants. We have also increased our direct marketing efforts through the use of e-mail. Several of our units, mostly in coastal areas, have enjoyed year-over-year sales improvements as tourism continued to strengthen through the summer months of 2004.

In January 2004, we closed an under-performing restaurant which was sold in the second quarter of 2004 at a net gain of $89,000. In May, we chose not to renew a costly lease and closed a second under-performing store. A third restaurant was closed in August as the lease expired and the building is set for demolition. The closure of these units will reduce our overall sales going forward, but the net affect to our net income and cash flow from operations is expected to be favorable. Once we achieve desired levels of financial performance, we will again look to increase our number of operating restaurants.

There are no assurances that the implementation of our strategies will result in sales and customer traffic gains which are required to meet our contemplated cash flow requirements. If cash flow requirements are not met, there are no assurances that financing options will be available to us or that our business plan will not be significantly hampered by our cash position.

On June 23, 2004, GCM Shells Seafood Partners, LLC and Trinad Capital, LP purchased from Shells Investment Partners, LLC ("SIP") a $1,000,000 principal amount promissory note issued by Shells in January 2002, in connection with our $2,000,000 financing. Deferred interest payable to SIP of $165,000 was refinanced and secured by a mortgage on certain real estate owned by us. The deferred interest owed to SIP is to be repaid in 24 equal monthly payments commencing in June 2005. The balance of the deferred interest owed to the other note holders has been deferred until January 31, 2007.

On August 4, 2004, our $2,000,000 aggregate principal amount of secured promissory notes set to mature on January 31, 2005 were extended to be due on January 31, 2007, under the same terms as the original notes. As an inducement to extend the maturity date of the notes, warrants to purchase 2,000,000 shares of Common Stock at an exercise price of $0.50 per share were issued to the note holders in proportion to the value of their respective notes. These newly issued warrants are exercisable from January 31, 2005 through January 31, 2007. The Company recognized a one-time, non-cash charge of $446,000 relating to this transaction.

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

	13 Weeks Ended		26 Weeks
	June 27, 2004	June 29, 2003	June 27, 2004
REVENUES	100.0%	100.0%	100.0%
COST AND EXPENSES:			
Cost of revenues	33.9%	33.0%	33.2%
Labor and other related expenses	29.6%	29.4%	29.7%
Other restaurant operating expenses	22.8%	24.2%	22.6%
Total restaurant costs and expenses	86.3%	86.6%	85.5%
General and administrative expenses	7.9%	7.3%	7.0%
Depreciation and amortization	2.6%	2.2%	2.5%
Income from operations	3.2%	3.9%	5.0%
Interest expense, net	-0.9%	-1.0%	-0.9%
Other expense, net	0.7%	-0.3%	0.2%
Elimination of minority partner interest	-0.6%	-0.6%	-0.6%
Income before provision for taxes	2.4%	2.0%	3.7%
Provision for income taxes	0.0%	0.0%	0.0%
Net income	2.4%	2.0%	3.7%

RESULTS OF OPERATIONS

13 weeks ended June 27, 2004 and June 29, 2003

Revenues. Total revenues for the second quarter of 2004 were

$10,997,000 as compared to $11,901,000 for the second quarter of 2003. The $904,000, or 7.6%, decrease in revenues was due to a 4.2% decrease in comparable store sales and the closing of two restaurants during the first half of 2004. Comparisons of same store sales include only stores which 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 increased to 33.9% for the second quarter of 2004 from 33.0% for the second quarter of 2003. This increase primarily related to increases in dairy and chicken commodity prices, which are expected to remain elevated in the near term. There was a non-recurring write-down of inventory of $36,000 in the second quarter of 2003. Exclusive of the non-recurring item, cost of revenues was 32.7% for the second quarter of 2003. The Company is continually attempting to anticipate and reacting 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 its 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 29.6% during the second quarter of 2004 as compared to 29.4% for the second quarter of 2003. This increase was due to increases in cleaning costs and benefits and taxes compared to the prior year. The increase in cleaning costs resulted from services being performed by our employees this year compared to outsourcing last year. We benefited from second quarter non-recurring reductions in benefits and taxes relating to workers compensation insurance reserve reductions and corresponding refunds of $161,000 and $197,000 in 2004 and 2003, respectively, of which $142,000 and $182,000 were allocated to restaurant labor costs. Exclusive of the non-recurring items, labor and other related expenses as a percentage of revenues was 30.8% and 30.9% for the second quarters of 2004 and 2003, respectively.

Other restaurant operating expenses. Other restaurant operating expenses as a percentage of revenues decreased to 22.8% for the second quarter of 2004 as compared with 24.2% for the second quarter of 2003. The decrease primarily was due to decreases in contract cleaning services and repairs and maintenance.

General and administrative expenses. General and administrative expenses were $866,000, or 7.9% as a percentage of revenues, for the second quarter of 2004 compared to $874,000, or 7.3% as a percentage of revenues, for the second quarter of 2003. There was a one-time non-recurring charge for severance of $39,000 in the second quarter of 2004 for downsizing of administrative personnel. Exclusive of this one-time charge, general and administrative expenses were 7.5% as a percentage of revenues for the second quarter of 2004. Excluding the one-time charge, the decrease in dollar expenditures was primarily due to decreases in consulting fees.

Depreciation and amortization. Depreciation and amortization expense as a percentage of revenues was 2.6% and 2.2% for the second quarters of 2004 and 2003, respectively.

Interest expense, net. Interest expense was $104,000 in the second quarter of 2004 compared to $115,000 in the second quarter of 2003. The decrease was primarily related to the reduction of loan balances outstanding.

Provision for income taxes. No provision or benefit for income taxes was recognized for the second quarter of 2004 or 2003 based on annual projected taxable income, as adjusted for net operating loss carry forwards.

Income from operations and net income. As a result of the factors discussed above, we had income from operations of $358,000 for the second quarter of 2004 compared to $461,000 for the second quarter of 2003. Exclusive of non-recurring items noted above, income from operations was $236,000 and $300,000 for the second quarters of 2004 and 2003, respectively. Shells had net income of $258,000 for the second quarter of 2004 compared to $244,000 for the second quarter of 2003. Exclusive of nonrecurring charges, net income was $47,000 and $83,000 for the second quarters of 2004 and 2003, respectively. A non-recurring item affecting net income for the second quarter of 2004 included an $89,000 gain on the sale of property.

26 weeks ended June 27, 2004 and June 29, 2003

Revenues. Total revenues for the 26 weeks ended June 27, 2004 were $23,588,000 as compared to $24,913,000 for the 26 weeks ended June 29, 2003. The $1,325,000, or 5.3%, decrease primarily was due to a reduction in same store sales of 2.8% in addition to the closing of two units in the first half of 2004.

Cost of revenues. The cost of revenues as a percentage of revenues increased to 33.2% for the 26 weeks ended June 27, 2004 from 32.7% for the comparable period in 2003. This increase primarily related to increases in dairy and chicken commodity prices, which are expected to remain elevated in the near term. There was 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 26 weeks ended June 29, 2003.

Labor and other related expenses. Labor and other related expenses increased to 29.7% as a percentage of revenues for the 26 weeks ended June 27, 2004 as compared to 29.5% for the same period in 2003. This increase was due to increases in cleaning costs and benefits and taxes compared to the prior year. The increase in cleaning costs resulted from services being performed by our employees this year compared to outsourcing last year. We benefited from second quarter non-recurring reductions in benefits and taxes relating to workers compensation insurance reserve reductions and corresponding refunds of $161,000 and $197,000 in 2004 and 2003, respectively, of which $142,000 and $182,000 were allocated to restaurant labor costs. Exclusive of the non-recurring items, labor and other related expenses as a percentage of revenues was 30.3% and 30.2% for the 26 weeks of 2004 and 2003, respectively.

Other restaurant operating expenses. Other restaurant operating expenses decreased to 22.6% as a percentage of revenues for the 26 weeks ended June 27, 2004 as compared with 22.9% for the same period in 2003. The decrease primarily was due to decreases in contract cleaning services and repairs and maintenance.

General and administrative expenses. General and administrative expenses were $1,659,000, or 7.0% as a percentage of revenues, for the 26 weeks ended June 27, 2004 compared to $1,714,000, or 6.9% as a percentage of revenues, for the same period in 2003. This decrease in dollar expenditures was primarily due to decreases in consulting fees. A non-recurring charge of $39,000 for severance pay occurred in 2004. Exclusive of this non-recurring item, general and administrative expenses were 6.9% as a percentage of revenues for the first six months of 2004.

Depreciation and amortization. Depreciation and amortization expenses as a percentage of revenues was 2.5% for the 26 weeks ended June 27, 2004 compared to 2.1% for the prior year.

Interest expense, net. Interest expense was $205,000 in the 26 weeks ending June 27, 2004 compared to $238,000 in the same period of 2003. The decrease was primarily related to the reduction of loan balances outstanding.

Income from operations and net income. As a result of the factors discussed above, the Company's income from operations was $1,190,000 for the 26 weeks ended June 27, 2004 compared to $1,464,000 for the same period in 2003. Exclusive of non-recurring items noted above, the Company's income from operations was $1,068,000 and $1,303,000 for the 26 weeks ended June 27, 2004 and June 29, 2003, respectively. The Company's net income for the 26 weeks ended June 27, 2004 was $903,000 compared to $1,028,000 in the same period in 2003. Exclusive of non-recurring items, the Company's net income was $692,000 and $867,000 for the 26 weeks ended June 27, 2004 and June 29, 2003, respectively. A non-recurring item affecting net income for the 26 weeks ended June 27, 2004 included an $89,000 gain on the sale of property.

LIQUIDITY AND CAPITAL RESOURCES

On August 4, 2004, our $2,000,000 aggregate principal amount of secured promissory notes set to mature on January 31, 2005 were extended to be due on January 31, 2007, under the same terms as the original notes. As an inducement to extend the maturity date of the notes, warrants to purchase 2,000,000 shares of Common Stock at an exercise price of $0.50 per share were issued to the note holders in proportion to the value of their respective notes. These newly issued warrants are exercisable from January 31, 2005 through January 31, 2007. The Company recognized a one-time, non-cash charge of $446,000 relating to this transaction.

On June 23, 2004, GCM Shells Seafood Partners, LLC and Trinad Capital, LP purchased from Shells Investment Partners, LLC ("SIP") a $1,000,000 principal amount promissory note issued by Shells in January 2002, in connection with our $2,000,000 financing. Deferred interest payable to SIP of $165,000 was refinanced and secured by a mortgage on certain real estate owned by us. The deferred interest owed to SIP is to be repaid in 24 equal monthly payments commencing in June 2005. The balance of the deferred interest owed to the other note holders has been deferred until January 31, 2007.

As of June 27, 2004, the Company's current liabilities of $6,815,000 exceeded its current assets of $2,151,000, resulting in a working capital deficiency of $4,664,000. In comparison, the December 28, 2003 working capital deficiency was $3,606,000. The increase in the working capital deficiency primarily related to the reclassification of the $2,000,000 debt, originally maturing January 31, 2005, as current debt. Subsequent to second quarter of 2004 end, the $2,000,000 debt was refinanced and now matures on January 31, 2007.

Our operating leverage has decreased. We may still encounter operating pressures from declining sales, increasing food, labor or other operating costs or additional restaurant disposition costs. Historically, we have 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.

Cash provided by operating activities for the 26 weeks ended June 27, 2004 was $735,000 compared to $226,000 for the comparable period in 2003. The net increase of $509,000 compared to the same period in 2003 primarily related to favorable variances in other current assets associated with a reduction in prepaid insurance, the timing of payments for accounts payable, accrued expenses relating to payroll and bonuses and a gain on the sale of assets, partially offset by a decrease in net income.

The cash used in investing activities was $379,000 for the 26 weeks ended June 27, 2004 compared to $393,000 for the same period in 2003; or a net decrease of $14,000. Proceeds from the sale of assets of $89,000 related to the sale of a restaurant location in the second quarter of 2004, which discontinued operations in the first quarter of 2004. The increase in capital expenditures to $468,000 for the 26 weeks ended June 27, 2004 compared to $393,000 for the same period in 2003, primarily related to restaurant remodelings.

The cash used in financing activities was $27,000 for the 26 weeks ended June 27, 2004 compared to $48,000 for the comparable period in 2003. The net decrease of $21,000 primarily related to a change in how we acquire and finance insurance, partially offset by a reduction in required debt payments and proceeds from the exercise of common stock options. In 2004, the annual premium for general liability and property insurance is being paid ratably throughout the year, as compared to 2003 when the annual premium was financed as a lump sum at the beginning of the year.

During October 2002, we refinanced through Colonial Bank two of our restaurant locations, Melbourne and Winter Haven, with notes of $635,000 and $667,000, respectively. The principal balances owed on these two notes as of June 27, 2004 were $559,000 and $593,000, respectively. Relative to these two promissory notes, we are required to meet a financial covenant relating to debt coverage. As of June 27, 2004, we were not in compliance in meeting this loan covenant. We received a loan covenant waiver from Colonial Bank, which is to be applied through the second quarter of Fiscal 2004. There can be no assurances that Colonial Bank will continue to provide us with a waiver to the extent we do not meet our financial covenants.

We have, from time-to-time utilized, and to the extent applicable may utilize real estate mortgage and restaurant equipment financing with various banks or financing institutions as necessary. In the event that our plans change, assumptions prove to be inaccurate, or expenses are higher than anticipated, and in the event projected cash flow proves to be insufficient to fund operations, we could be required to seek additional third party financing. In addition, remodeling our restaurants chain-wide would require significant capital investment. There can be no assurance that third party financing will be available to us when needed, on acceptable terms, or at all.

QUARTERLY FLUCTUATION OF FINANCIAL RESULTS

The restaurant industry in general is seasonal, depending on restaurant location and the type of food served. We have experienced fluctuations in our quarter-to-quarter operating results due, in large measure, to our full concentration of restaurants in Florida. Business in Florida is influenced by seasonality due to various factors, which include but are not limited to weather conditions in Florida relative to other areas of the U.S. and the health of Florida's economy and the effect of world events in general and 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. Many of our restaurant locations are in coastal cities, where sales are significantly dependent on tourism and its seasonality patterns.

In addition, quarterly results have been substantially affected by the timing of restaurant closings or openings. Because of the seasonality of our business and the impact of restaurant closings, 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 $1,152,000 in 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

We maintain "disclosure controls and procedures," as such term is defined under Securities Exchange Act Rule 13a-15(e), 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 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. As required by SEC Rule 13a-15(b), 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 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.

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Part II. OTHER INFORMATION

Item 1. Legal Proceedings

On June 21, 2002, we brought legal action against The Lark Group LLC, Best Que LLC, and Michael Sloane, II, in the United States District Court, Middle District of Florida, Tampa Division, relating to their purchase of assets and leasehold rights for two Midwest locations. Our complaint sought relief for breaches of contract against each of the defendants. Defendants consented to a final judgment in the amount of $188,201, which was filed with the Court on January 22, 2003. We are continuing to take steps to vigorously pursue collection of this judgment.

On May 24, 2004, we received a notice from the Equal Employment Opportunity Commission (EEOC) that a former employee in a Ft. Lauderdale Shells restaurant had filed a charge of discrimination with the EEOC. Shells terminated the employment of this person in May 2004. Specifically, this former employee claimed race and national origin discrimination under Title VII of the Civil Rights Act of 1964. Based on our investigation to date we believe the charge is meritless and intend to vigorously defend our position.

In the ordinary course of business, the Company is and may be a party to various legal proceedings, the outcome of which, singly or in the aggregate, is not expected to be material to the Company's financial position, results of operations or cash flows.

Item 2. Changes in Securities and Use of Proceeds

During April 2004, a former employee acquired 20,000 shares of Common Stock by exercising stock options, resulting in net proceeds to the Company of $8,400. The proceeds were used for working capital requirements.

During June 2004, an accredited investor converted 28,273 shares of Preferred Stock into 141,365 shares of Common Stock. There were no proceeds to the Company for this transaction.

Item 3. Defaults Upon Senior Securities

None

Item 4. Submission of Matters to a Vote of Security Holders

At the Company's Annual Meeting of Stockholders held on May 5, 2004, the following directors were elected by the votes indicated:

Philip R. Chapman: 4,235,592 For, 14,400 Against or Withheld, 0 Abstaining
J. Stephen Gardner:4,235,592 For, 14,400 Against or Withheld, 0 Abstaining
John N. Giordano: 4,235,592 For, 14,400 Against or Withheld, 0 Abstaining
Michael R. Golding: 4,235,092 For, 14,900 Against or Withheld, 0 Abstaining
Christopher D. Illick: 4,235,592 For, 14,400 Against or Withheld,0 Abstaining
Thomas R. Newkirk: 4,235,592 For, 14,400 Against or Withheld, 0 Abstaining

Item 5. Other Information

On July 29, 2004, the Board of Directors appointed our President and Chief Executive Officer, Leslie J. Christon, as a seventh board member. Additionally, the Board of Directors rescinded the status of William Hattaway and George Heaton as Board Observers.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

31.1 Certification of Chief Executive Officer under Rule 13a-14(a)
31.2 Certification of Chief Financial Officer under Rule 13a-14(a)
32.1 Certification of Chief Executive Officer and Chief Financial Officer under Section 906

(b) Current reports on Form 8-K filed during the fiscal quarter ended June 27, 2004:

The Company filed a current report on Form 8-K, Items 1 and 7, on April 27, 2004 announcing that Frederick R. Adler purchased a $1,000,000 promissory note issued by the Company to Banyon Investments, LLC on January 31, 2002.

The Company filed a current report on Form 8-K, Item 12, regarding a press release on April 30, 2004 announcing operating results for the quarter ended March 28, 2004.

The Company filed a current report on Form 8-K, Item 5, regarding a press release on May 19, 2004 announcing the grand reopening of the West Palm Beach location.

The Company filed a current report on Form 8-K, Items 1 and 7, on June 23, 2004 announcing that GCM Shells Seafood Partners, LLC and Trinad Capital, LP purchased a $1,000,000 promissory note issued by the Company to Shells Investment Partners, LLC on January 31, 2002.

The Company filed a current report on Form 8-K, Item 12, regarding a press release on July 23, 2004 announcing operating results for the quarter ended June 27, 2004.

The Company filed a current report on Form 8-K, Items 5 and 7, regarding a press release on August 4, 2004 announcing the extension of the secured senior notes and the appointment of Leslie J. Christon to the Board of Directors.

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)

/s/ Leslie J. Christon
President and Chief Executive Officer
August 11, 2004

/s/ Warren R. Nelson
Executive Vice President and Chief Financial Officer
August 11, 2004