SHELLS SEAFOOD RESTAURANTS INC
Form 10-K
March 26, 2004
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x **Annual Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**

For the Fiscal Year (52 Weeks) ended December 28, 2003.

Or

¨ **Transition Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934**

For the period from______ to ______.

Commission File Number 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, Tampa, Florida 33618

(Address of principal executive offices) (Zip Code)

(813) 961-0944

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12 (b) of the Act:

None

Securities registered pursuant to Section 12 (g) of the Act:

Common Stock, $.01 par value.

(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

The aggregate market value of the Common Stock held by non-affiliates of the Registrant (based upon the last sales price of the Common Stock reported on the over-the-counter bulletin board and the assumption, for this computation only, that all directors, executive officers, and ten-percent holders of stock are affiliates of the Registrant) at June 27, 2003 (the last business day of the Registrant s most recently completed second fiscal quarter) was $1,690,560.

As of March 19, 2004, the number of shares outstanding of the Registrant s Common Stock, $.01 par value, was 4,651,375.

DOCUMENTS INCORPORATED BY REFERENCE

Our Proxy Statement to be filed with the Securities and Exchange Commission in connection with solicitations of proxies for our upcoming Annual Meeting of Stockholders scheduled to be held on May 5, 2004, is incorporated by reference in Part III, Items 10, 11, 12 and 13 of this Form 10-K.

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FORWARD LOOKING STATEMENTS

When used in this Annual Report on Form 10-K, the words believes , anticipates , expects , and similar expressions are intended to identify forward-looking statements. These statements are subject to certain risks and uncertainties, which could cause actual results to differ materially from those projected.

In addition to seasonal fluctuations, our quarterly and annual operating results are affected by a wide variety of other factors that could materially and adversely affect our revenues and profitability, including changes in consumer preferences, tastes and eating habits; increases in food and labor costs; promotional timings and seasonality; the availability of qualified labor; national, regional and local economic and weather conditions; demographic trends and traffic patterns; changes in travel and tourism tendencies, particularly in light of world events; competition from other restaurants and food service establishments; cash balances available for operating activities; and the timing, costs and charges relating to restaurant openings and closings. As a result of these and other factors, we may experience material fluctuations in future operating results on a quarterly or annual basis, which could materially and adversely affect our business, financial condition, operating results, and stock price. An investment in our company involves various risks, including those which are detailed in this document and from time-to-time in our other filings with the Securities and Exchange Commission.

Any forward-looking statements included in this Annual Report speak only as of the date of this document. We are not undertaking any obligation to publicly release the results of any revisions to these forward-looking statements which may be made to reflect events or circumstances after the date of this document or to reflect the occurrence of unanticipated events.

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PART I

ITEM 1. BUSINESS

Shells Seafood Restaurants, Inc. was incorporated under the laws of the State of Florida in April 1993 and was reincorporated under the laws of the State of Delaware in April 1996. Effective December 1994, Shells, Inc., a company incorporated under the laws of the State of Florida, was merged with and into our company and became our wholly owned subsidiary.

Concept and Strategy

Shells is a full-service, neighborhood concept, designed to appeal to a broad range of customers by providing generous portions of high-quality seafood, warm, friendly service, and a relaxed atmosphere at reasonable prices. Shells restaurants feature a wide selection of seafood items, including shrimp, oysters, clams, scallops, lobster, crab and daily fresh fish specials, cooked to order in a variety of ways: steamed, sautéed, grilled, blackened and fried. In addition, our restaurants offer a wide selection of signature pasta dishes, appetizers, salads, and desserts and full bar service. All Shells restaurants are open for dinner and 19 restaurant locations are also open for lunch.

To enhance Shells name recognition and benefit from customer loyalty, our restaurants share several proto-typical elements, including the exterior Shells logo sign and similar interior décor schemes that reflect our commitment to promoting a casual, fun dining experience.

As of December 28, 2003 (the last date of our 2003 fiscal year), we owned 23 Shells restaurants, owned a 51% ownership interest in one Shells restaurant and managed four additional Shells restaurants pursuant to contractual arrangements. Subsequently, we discontinued operations in one restaurant in January 2004. All of our restaurants are located in Florida.

Fiscal 2003 was a year of transition for Shells, with several changes in our executive management personnel. On July 7, 2003, Leslie J. Christon joined Shells as our President and Chief Executive Officer; and on September 24, 2003, Guy C. Kathman joined Shells as our Vice President of Operations.

During the second half of 2003, the new leadership began several significant shifts in strategy focused on reversing the long-term decline in customer traffic and sales that Shells has experienced. An immediate focus was taking the necessary steps to elevate service and cleanliness operating standards. Marketing was brought back in house, under a new marketing executive, and plans were revamped to better balance efforts to attract new customers with programs geared for increasing frequency of existing customers. Part of this shift was to increase our focus on the quality, service and overall experience guests receive when they dine at Shells, in addition to our continuing emphasis on price value.

At the same time, we began taking several important steps to update the Shells concept, taking into account the major shifts in consumer tastes that have taken place in recent years. We developed, tested and trained extensively to get ready for the launch of the new food and beverage menus we rolled out during the first quarter of 2004. We tested new color schemes, introduced new uniforms and began evaluating other elements of Shells décor and atmosphere.

Consumer expectations continue to heighten in terms of food quality, flavors and variety, service, pricing, convenience and dining atmosphere. We strive to keep these factors in balance, recognizing that each is important in defining overall value to the customer.

Restaurant Locations

Our managed and operated restaurants are located in the following Florida markets and cities/neighborhoods:

Tampa/Sarasota	Orlando	South Florida
Brandon	Daytona Beach	Coral Springs
Clearwater	Kissimmee	Davie
Holmes Beach	New Smyrna Beach	Ft. Lauderdale
Redington Shores	Ocala	Kendall
St. Petersburg (closed 1/31/04)	Orlando	Pembroke Pines
St. Pete Beach	Winter Park	Sunrise
Winter Haven	Melbourne	
Carrollwood		
North Tampa		
Sarasota		
South Tampa		

West Palm Beach	Fort Myers
Stuart	Fort Myers
West Palm Beach	Port Charlotte

From 1997 to 1999, in an attempt to diversify and minimize the seasonal effect of the Florida market, we opened 18 restaurants in various Midwest markets. We sustained operating losses in these Midwest markets and completed the discontinuance of our Midwest operations in April 2001, closing the remaining nine units. We closed one under-performing Florida restaurant in 2002 and an additional restaurant in January 2004. We continuously review the performance of each restaurant unit economics and location, and regularly evaluate new real estate sites in Florida for potential expansion or relocation.

Restaurant Operations

Management and Employees. We currently employ five area directors. Each area director is responsible for the management of several restaurants, including management development, recruiting, training, quality of operations and unit profitability. The staff of a typical dinner-only restaurant consists of one general manager and two assistant managers and approximately 45 other employees. The restaurants that are also open for lunch generally have 15 to 20 additional part-time employees. Restaurant management participates in a bonus program based upon the financial results of their particular restaurant.

Restaurant Reporting. We maintain financial and accounting controls for each restaurant through a central accounting system. Our financial systems and controls allow us to access each restaurant s sales, inventory costs and other financial data on a real-time basis, enabling both store-level management and

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senior management to quickly react to changing sales trends, to effectively manage food, beverage and labor costs, to minimize theft, and to improve the quality and efficiency of accounting and audit procedures. Store level management performs weekly inventories and manages weekly operating results versus budget.

Recruitment and Training. We believe that achieving customer satisfaction by providing knowledgeable, friendly, efficient service is critical to a restaurants long-term success. We typically recruit restaurant managers with significant experience in the restaurant industry. During a 12-week training program, restaurant managers are taught to promote our team-oriented atmosphere among restaurant employees with emphasis on preparing and serving food in accordance with strict standards and providing friendly, courteous and attentive service. The restaurant staff, through our Team Trainer program, is trained on site by restaurant managers and other staff members. During both 2002 and 2003, we reduced restaurant management turnover. We are continuing to work on improving turnover levels.

Purchasing. Obtaining a reliable supply of quality seafood at competitive prices is critical to our success. We have formed long-term relationships with several seafood suppliers and purchase frozen seafood and certain other supplies used in restaurant operations in bulk. In addition, Shells menu has been designed to feature seafood varieties with stable sources of supply, as well as to provide flexibility to adjust to shortages and to take advantage of occasional purchasing opportunities. We believe our diverse menu selection minimizes the effect of the shortage of any seafood products. We generally have been able to anticipate and react to fluctuations in food costs through selected menu price adjustments, purchasing seafood directly from numerous suppliers and promoting certain alternative menu selections in response to availability and price of supply.

Performance Food Group of Florida, our primary distributor since October 2002, distributes seafood and most other products to our restaurants, minimizing the risks relating to storing and distributing these products. Performance Food Group purchases and takes delivery of all frozen seafood that we recommend for purchase according to our specifications and subject to our inspections. Based on purchase orders initiated by our restaurants, Performance Food Group then sells the frozen seafood to us on a cost plus basis, and distributes the frozen seafood directly to the restaurants. From time-to-time, at our direction to facilitate a forward purchase opportunity, Performance Food Group acquires frozen seafood inventory in excess of normal recurring restaurant delivery and re-supply. We pay interest on inventory holdings above 30-day supply levels, at an interest rate of 7.8% per annum. In addition, Performance Food Group procures, on our behalf, many of the supplies, other than seafood, used by the restaurants and distributes and sells these products to the individual restaurants at agreed upon price mark-ups.

Quality Control. We maintain a continuous inspection program for all of our seafood purchases. Each shipment of frozen seafood is inspected through statistical sampling methods upon receipt at Performance Food Group s distribution center for quality and conformity to our written specifications, prior to delivery to the restaurants. In addition, fresh fish purchased by the individual restaurants must be purchased from one of our approved suppliers and is inspected by a restaurant manager at the time of delivery. As part of our training program, restaurant employees are educated as to the correct handling and proper physical characteristics of each product.

Our area directors, general managers and assistant managers are all responsible for properly training hourly employees and ensuring that Shells restaurants are operated in accordance with strict health and quality standards. Compliance with our quality standards is monitored by on-site visits and formal inspections by the area directors. We believe that our inspection procedures and employee training practices help to maintain a high standard of quality for the food and service we provide.

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Advertising and Marketing

Our marketing efforts leverage the use of billboard, newspaper, radio and television advertising to raise awareness of the Shells brand and to inform new and existing customers about food-focused promotions. The fact that our restaurants are generally clustered in particular media markets helps us obtain cost effective advertising. We also stage in-store promotions and various local marketing efforts to help our restaurants partner with their communities.

Disclosure Controls

Consolidated subsidiaries are managed through a centralized Executive Office in Tampa, Florida. Material information is discussed at various weekly and monthly meetings with officers and directors. An open door policy is observed by corporate officers to facilitate communication.

Joint Venture and Third-Party Owned Restaurants

The Shells restaurant system currently consists of (i) 22 restaurants that are wholly owned by us; (ii) one restaurant, in Melbourne, Florida, in which we have an interest of 51%; and (iii) four restaurants that we manage and operate, but do not own. The remaining 49% interest in the Melbourne restaurant is indirectly owned by Wanda L. Hattaway, wife of William E. Hattaway, a former director and president of our company. In addition to the equity interest in this restaurant, we receive a management and licensing fee of 6% of the restaurant sales of the Melbourne restaurant.

Three of the managed restaurants are managed and operated by us pursuant to management and license agreements, originally entered into in July 1993. Pursuant to these agreements, we provide management services and license proprietary information required to operate these restaurants for a percentage of that restaurant s sales. The agreement, as amended in October 2001, provides for a 4% management fee until such time as sales return near to 1999 levels, and then returning to a 6% fee. Of the total management fee received, 2% of sales is placed in escrow and disbursed to a third party to satisfy each managed restaurants requirement to make third party royalty payments. The management agreements grant us authority to determine the programs and policies affecting the day-to-day operations of each of these managed restaurants. Although the management agreements differ slightly, they generally have an initial term of 30 years and provide that the third-party owners are responsible for funding all the restaurant expenses, including food and beverage costs, staffing, training, recruiting, inventory, and working capital.

A major fire occurred at a managed restaurant in North Tampa on March 3, 2003. The restaurant reopened June 24, 2003 after restoration and renovation. Our management fees from this managed restaurant were not affected during Fiscal 2003, due to insurance coverages.

We operate the fourth managed restaurant pursuant to an oral agreement requiring that the restaurant is operated in conformity with the policies and procedures established by us for Shells restaurants. In accordance with the amended management agreement for our managed restaurants, beginning in October 2001, we receive a management fee of 2% of the restaurant s sales.

In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable.

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Competition

The restaurant industry is intensely competitive with respect to price, service, location, food quality and variety, and there are many well-established competitors with substantially greater financial and other resources than us. These competitors include national, regional and local full-service casual dining chains, many of which specialize in or offer seafood products. We also face competition from a broad range of other restaurants and foodservice establishments, including full-service, quick service and fast food restaurants, which specialize in a variety of cuisines. Some of our competitors have been in existence for substantially longer periods than we have, and may be better established in the markets where we have our restaurants. In addition, we believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products.

Government Regulation

We are subject to extensive federal, state and local government regulation by various governmental agencies, including state and local licensing, zoning, land use, construction and environmental regulations and various regulations relating to the sale of food and alcoholic beverages, sanitation, disposal of refuse and waste products, public health, safety and fire standards. Our restaurants are subject to periodic inspections by governmental agencies to ensure conformity with these regulations. Difficulties or failure in obtaining required licensing or other regulatory approvals could delay or prevent the opening of a new restaurant, and the suspension of, or inability to renew, a license at an existing restaurant could adversely affect our operations. Restaurant operating costs are also affected by other government actions, beyond our control, including increases in the minimum hourly wage requirements, workers compensation insurance rates, health care insurance costs and unemployment and other taxes.

Approximately 11% of our revenue is attributable to the sale of alcoholic beverages. Alcoholic beverage control regulations require each of our restaurants to apply to a state authority and, in certain locations, county or municipal authorities for a license or a permit to sell alcoholic beverages on the premises. Typically, licenses must be renewed annually and may be revoked or suspended for cause at any time. Alcoholic beverage control regulations relate to numerous aspects of daily operations of our restaurants, including minimum age of patrons and employees, hours of operation, wholesale purchasing, inventory control and handling, storage and dispensing of alcoholic beverages. The failure of a restaurant to obtain or retain liquor or food service licenses would adversely affect the restaurant s operations.

We are also subject to dram-shop statutes, which generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. We carry liquor liability coverage as part of our existing comprehensive general liability insurance.

Our restaurants are subject to federal and state minimum wage laws governing such matters as working conditions, overtime and tip credits. A significant number of our restaurant personnel are paid at rates related to the federal minimum wage and, accordingly, further increases in the minimum wage rate could increase our labor costs.

The Americans with Disabilities Act prohibits discrimination in employment and public accommodations on the basis of disability. Under the Act to the extent that we elect to remodel a restaurant, we could be required to expend funds to modify our restaurants to better provide service to, or make reasonable accommodations for the employment of, disabled persons.

Service Marks and Proprietary Information

We have registered the service mark Shells with the Secretary of the State of Florida and the Shells service mark and jumping fish logo with the United States Patent and Trademark Office. We believe that our service marks have significant value and are essential to our ability to create demand for, and awareness of, our restaurants. There can be no assurance, however, that our service marks do not or will not violate the proprietary rights of others, that they would be upheld if challenged or that we would not be prevented, in such an event, from using our service marks, any of which could have a material adverse effect on us. Although there can be no assurance that we will have the financial resources necessary to enforce or defend our service marks, we have vigorously opposed, and intend to continue to oppose vigorously, any infringement of our service marks.

We also rely on trade secrets and proprietary knowledge and employ various methods to protect our concepts and recipes. These methods may not afford complete protection and there can be no assurance that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes.

Employees

As of December 28, 2003, we employed approximately 1,400 persons, of whom approximately 110 were management or administrative personnel employed on a salaried basis and 1,290 were employed in non-management restaurant positions on an hourly basis. Approximately 700 employees are employed on a full-time basis. We consider our employee relations to be good. No employees are covered by a collective bargaining agreement.

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Our Executive Officers

Our executive officers are:

Name	Age	Position
Leslie J. Christon	49	President and Chief Executive Officer
Guy C. Kathman	47	Vice President of Operations
Warren R. Nelson	52	Executive Vice President of Finance, Chief Financial Officer, Treasurer and Secretary

Leslie J. Christon has been our President and Chief Executive Officer since joining Shells in July 2003. From 2002 to 2003, Mrs. Christon was self-employed as a management consultant in the restaurant industry. From 2000 to 2002, Mrs. Christon was employed by Sutton Place Gourmet, Inc. as its President and Chief Operating Officer. From 1996 to 2000, Mrs. Christon was employed by Brinker International, On the Border Restaurants, as its President.

Guy C. Kathman has been our Vice-President of Operations since joining Shells in September 2003. From 2001 to 2003, Mr. Kathman was employed by Posados Café as a General Manager. From 1997 to 2001, Mr. Kathman was employed by Brinker International, On the Border Restaurants, as a Regional Director.

Warren R. Nelson currently serves as our Executive Vice President of Finance, Chief Financial Officer, Treasurer, and Secretary, positions he has held since June 1993.

Our Board of Directors has adopted a Code of Business Conduct and Ethics that applies to our principal executive officer and principal financial officer, as well as to the members of our Board of Directors and our other officers and employees. This Code of Business Conduct and Ethics is available on our web site, at www.shellsseafood.com. We intend to satisfy the amendment and waiver disclosure requirements under applicable securities regulations by posting any amendments of, or waivers to, the Code of Business Conduct and Ethics on our web site. A copy of our Code of Business Conduct and Ethics will be sent without charge upon request in writing addressed to us at 16313 N. Dale Mabry Hwy, Suite 100, Tampa, Florida 33618 c/o Secretary.

Risk Factors Relating to the Business of the Company. *The risks and uncertainties described below are not the only risks we face. In addition to the following risk factors, we refer you to those risk factors described elsewhere in this Annual Report on Form 10-K and in various of our publicly reported documents. Additional risks and uncertainties not presently known to us or that we currently believe are immaterial could also impair our business operations.*

Keep these risk factors in mind when you read forward-looking statements elsewhere in this Form 10-K. These are statements that relate to our expectations for future events and time periods. Generally, the words anticipate, expect, intend and similar expressions identify forward-looking statements. Forward-looking statements involve risks and uncertainties. Future events and circumstances could differ significantly from those associated with the forward-looking statements.

We have significant capital requirements and may need additional financing. Historically, our cash requirements have exceeded our cash flow from operations. This has been due to costs associated with developing and opening restaurants as well as the operating performance of many of our restaurants. At December 29, 2002, the Company had a working capital deficiency of $3,116,000 and a

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cash balance of $2,469,000. In 2003, we incurred a net loss of $1,034,000 and we invested in property and equipment of $755,000. At December 28, 2003, the Company had a working capital deficiency of $3,606,000 and a cash balance of $724,000. We believe cash flow from operations will satisfy our contemplated cash requirements for our existing operations through the end of Fiscal 2004 providing we are successful in reversing the long-term trends in declining sales and customer traffic. 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.

Due to our minimal cash position, we may have to seek additional financing from other sources if:

- our projections or assumptions are inaccurate or because of unanticipated expenses;
- projected cash flows are not sufficient to cover costs of operations or restaurant renovations.

Integral to our business plan, we presently have plans to renovate and remodel existing restaurants in Fiscal 2004. If we do not achieve our operating cash flow requirements, our plans to renovate and remodel will be adversely affected. Additional cash also will be needed if new restaurants are opened or existing restaurants are relocated.

We cannot be assured that third party financing will be available to us when we need it or available on acceptable terms, if at all. If we cannot obtain third party financing or other financing when we need it, this could materially adversely affect our results of operations and ability to continue as a going concern. If we have to raise additional capital, our existing stockholders could be substantially diluted.

We may be unable to repay certain of our debt when it matures. On January 31, 2005, two notes totaling $2,000,000 will mature, for which payment will be due in full, along with deferred interest through the due date of $420,000. The notes are held by entities owned by or associated with various of the Company s directors and largest shareholder. The Company anticipates that it either will restructure this debt or will obtain alternative outside financing to replace these obligations. There are no assurances that these financing options will be available. In the absence of additional outside financing, we do not expect to be able to pay off these notes when they mature.

We have two promissory notes outstanding through Colonial Bank, for the financing of two restaurant locations, Melbourne and Winter Haven. As of December 28, 2003, we owed collectively $1,191,000 on the principal balances of these notes. We are required to meet a financial covenant relating to debt coverage. We were not in compliance in meeting this loan covenant as of December 28, 2003. Subsequently, we received a loan covenant waiver from Colonial Bank, which is to be applied through the first 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.

Going Concern. The Company has suffered from recurring losses from operations, has an accumulated deficit and has secured promissory notes which are due January 31, 2005 that raise substantial doubt about the Company s ability to continue as a going concern. Sufficient liquidity to make the scheduled debt reduction under the promissory note, and other debt obligations, is dependent primarily on the realization of cash flow from operations and obtaining alternative financing sources. There can be no assurance that these initiatives will be successful. The Company s independent auditors have included an explanatory paragraph in their report on the Company s financial statements, stating that they have been prepared assuming that the Company will continue as a going concern and that the Company s recurring losses from operations and net working capital deficiency raise substantial doubt about the Company s ability to continue as a going concern.

Substantial dilution to our stockholders is possible. During January 2002, we completed a $2,000,000 financing transaction pursuant to which, among other things, we issued warrants to purchase 8,908,030 shares of our common stock, at an exercise price of $0.16 per share. The warrants are

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exercisable through January 31, 2005, and may be exercised by a cashless exercise . The $2,000,000 borrowed, together with the $420,000 of accrued interest, is scheduled to be due and payable on January 31, 2005. In the event we renegotiate the payment of this indebtedness, it is possible that we would extend some or all of these warrants beyond January 2005. To the extent these warrants are exercised, our stockholders will suffer substantial dilution. In addition, it is likely that until the warrants are exercised, the number of shares which are issuable upon exercise of these warrants, combined with the per share exercise price, will have a depressive effect on the price of our stock.

Control by Management and Certain Individuals. Frederick R. Adler, a significant shareholder, together with members of our executive management team and Board of Directors, own of record, in the aggregate, approximately 37% of our outstanding common stock. As a result, these persons, acting together, will be able to exert significant influence and control over us, including the election of our directors, regarding any proposed dissolution, merger or sale of our assets, and generally in the direction of our affairs.

In addition, in conjunction with the $2,000,000 financing transaction in 2002, we issued warrants to purchase 8,908,030 shares of our common stock, at an exercise price of $0.16 per share. The warrants, which may be exercised by a cashless exercise, are exercisable through January 31, 2005. One half of these warrants are held by each of two investor groups, the members of which are either members of our Board of Directors or persons associated with our Board members or Mr. Adler. If these warrants are exercised in full, our corporate insiders, together with Mr. Adler, could control approximately 75% of our outstanding voting stock, and thus control all decisions affecting our company. Furthermore, as part of the financing, we entered into an Investor Rights Agreement, dated as of January 31, 2002, with these investor groups and certain other stockholders. Pursuant to this agreement, the composition of our Board of Directors may total seven members and each of these investor groups is entitled to nominate three individuals to serve on our Board. Additionally, both of these investor groups and Frederick R. Adler, among others, have agreed to vote their respective shares, to cause these slated nominees to be elected to our Board of Directors.

We have experienced significant turnover at the management level. In Fiscal 2003, we experienced significant change in our senior management. Such turnover has affected and may continue to affect our strategic direction, causing changes in our business plan or disruption in the timing of its implementation.

Operating results may require the closure of other restaurants. If we continue to experience prolonged periods of unfavorable operating results at existing restaurants or view the prospects for a restaurant to be less than satisfactory, we may elect to close or relocate restaurants. The lack of success or closing of any of our restaurants could have an adverse effect upon our financial condition and results of operations. We closed 16 restaurants during Fiscal 2001, of which 14 were located in the Midwest and two were located in Florida. We closed one restaurant in Fiscal 2002. An additional restaurant closed January 2004. We are continuing to monitor the operations and financial performance with respect to certain of our other existing restaurants.

Our operating results fluctuate seasonally because of our geographic concentration. We experience significant fluctuations in our quarter-to-quarter operating results because of factors including:

- the seasonal nature of our business; and
- weather conditions in Florida.

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Our restaurants are all located in Florida and can be affected by the health of Florida s economy in general, and of the tourism industry in particular, which can further be affected by anticipated world events, as well as economic trends. In addition, while the majority of our restaurants are located primarily in residential areas in Florida, many of our restaurants are located in seasonal tourist areas.

Our restaurant sales generally increase from January through April and June through August, the peaks of the Florida tourism season, and generally decrease from September through mid-December. In addition, because of our present geographic concentration, adverse publicity relating to our restaurants or adverse weather conditions could have a more pronounced adverse effect on our operating results than if our restaurants were more geographically dispersed. Adverse weather conditions or a decline in tourism in Florida, or in general economic conditions, which would likely affect the Florida economy or tourism industry, particularly during the time of peak sales, could materially adversely affect our operations and prospects. Because of the seasonality of our business, our results for any quarter are not necessarily indicative of the results that may be achieved for a full year.

The supply and quality of our seafood may fluctuate. In recent years, the availability of certain types of seafood has fluctuated. This has resulted in a corresponding fluctuation in prices. We maintain short-term contracts with several of our suppliers. In addition, we purchase products through Performance Food Group in the ordinary course of business. Performance Food Group distributes and warehouses our frozen seafood supply and procures, distributes and stores other supplies for us. We believe that our relationships with our suppliers and Performance Food Group are satisfactory and that alternative sources are readily available. However, the loss of some suppliers or of our relationship with Performance Food Group could materially adversely affect us.

Some species of seafood have become subject to adverse publicity because of claims of contamination by lead, mercury or other chemicals that may exist in the ocean or in an aquaculture environment. This can adversely affect both market demand and supply for these food products. Customer demand may also be negatively impacted by reports of medical or other risks resulting from eating seafood. We maintain a continuous inspection program for our seafood purchases. However, we cannot assure you that seafood contamination or consumer perception of inadequate seafood quality, in the industry in general or as to us specifically, will not have a material adverse effect on us. Our failure to obtain adequate supplies of seafood or problems or difficulties resulting from the contamination of seafood, in general, or at any of our restaurants in particular, will have a material adverse effect on our operations and profitability.

Our expenses for food and other costs fluctuate. Our profitability depends on our ability to anticipate and to react to increases in food, labor, employee benefits, and similar costs. We have limited control over these costs. Specifically, our dependence on frequent deliveries of seafood, produce, dairy and other products means we are at greater risk of shortages or interruptions in supply because of adverse weather or other conditions. This could adversely affect the availability and cost of these items. Also, substantial price increases imposed by our suppliers in the absence of alternative sources of supply in a timely manner, could have a material adverse effect on us. We have been able to anticipate and react to fluctuations in food costs by:

- adjusting selected menu prices;
- purchasing seafood directly from numerous suppliers; and

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- promoting alternative menu selections in response to price and availability of supply.

However, we cannot assure you that we will be able to continue to anticipate and respond to supply and price fluctuations or that we will not be subject to significantly increased costs. A shortage of available seafood could cause our cost of sales to increase. Because of our low pricing structure, this could materially adversely affect our operations and profitability. In addition, seafood suppliers and processors are subject to a program of inspection by the Food and Drug Administration. This program may increase our seafood costs because seafood suppliers and processors costs in complying with this program may increase.

Our industry is highly competitive. The restaurant industry, particularly the full-service casual dining segment, is highly competitive. We compete in the areas of:

- price;
- service;
- food quality, including taste, freshness, healthfulness and nutritional value; and
- location.

We have numerous well-established competitors, some of which dominate the industry. These competitors possess substantially greater financial, marketing, personnel and other resources than we do. Many of our competitors have achieved significant brand name and product recognition. They also engage in extensive advertising and promotional programs, both generally and in response to efforts by additional competitors to enter new markets or introduce new products. Our competitors include national, regional and local full-service casual dining chains, many of which specialize in or offer seafood products.

We believe that the full-service casual dining segment is likely to attract a significant number of new entrants, some offering seafood products. We also expect to face competition from a broad range of other restaurants and food service establishments. These include full-service, quick-service and fast food restaurants, which specialize in a variety of menu offerings. In addition, the full-service restaurant industry is characterized by the frequent introduction of new food products, which are accompanied by substantial promotional campaigns. In recent years, numerous companies in the full-service restaurant industry have introduced products, including seafood, intended to capitalize on growing consumer preference for food products that are, or are perceived to be, healthful, nutritious, low in calories and low in fat content. You can expect that we will be subject to increasing competition from companies whose products or marketing strategies address these consumer preferences. While we believe that we offer a broad variety of quality seafood products, we cannot assure you that:

- consumers will be able to distinguish our products from competitive products;
- substantially equivalent food products will not be introduced by our competitors; or
- we will be able to compete successfully.

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Many factors affect our industry. We must respond to various factors affecting the restaurant industry including:

- changes in consumer preferences, tastes and eating habits;
- demographic trends and traffic patterns;
- increases in food and labor costs;
- inflation; and
- national, regional and local economic conditions and the effect of world events, in general, and the tourism industry in particular:

We face risks associated with government regulation. We are subject to extensive state and local government regulation by various agencies, including:

- state and local licensing, zoning, land use, construction and environmental regulations;
- various regulations relating to the sale of food and alcoholic beverages;
- regulations relating to sanitation, disposal of refuse and waste products;
- regulations relating to public health; and
- safety and fire standards.

Our restaurants are inspected periodically by governmental agencies to ensure conformity with these regulations. The suspension of, or inability to renew a license at an existing restaurant would adversely affect our operations. A significant percentage of our revenue comes from sales of alcoholic beverages. State and local regulation of the sale of alcoholic beverages require us to obtain a license or permit for each of our restaurants. The failure of a restaurant to obtain or retain a license to serve liquor would materially adversely affect our operations. In addition, our failure or difficulty in obtaining required licensing or other regulatory approvals could delay or prevent new restaurant openings.

Restaurant operating costs are also affected by other government actions, which are beyond our control, including increases in:

- the minimum hourly wage requirements;
- workers compensation insurance rates;

health care insurance costs;

other insurance costs, including general liability and property; and

unemployment and other taxes.

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Furthermore, the Americans with Disabilities Act may require us to make certain modifications to certain of our restaurants to meet specified access and use requirements. These and other initiatives could adversely affect our results of operations.

We may have liability for sales of alcoholic beverages. We are also subject to dram-shop statutes. These statutes generally provide a person injured by an intoxicated person the right to recover damages from an establishment that wrongfully served alcoholic beverages to the intoxicated person. In certain states, statutes also provide that a vendor of alcoholic beverages may be held liable in a civil cause of action for injury or damage caused by or resulting from the intoxication of a minor under certain conditions. In addition, significant national attention is currently focused on the problem of drunk driving, which could result in the adoption of additional legislation. This could increase our potential liability for damage or injury caused by our customers.

We may not be able to protect our service marks and proprietary information. We own two United States registrations for the service marks that we use, including the name *Shells.* We believe that our service marks have significant value and are essential to our ability to create demand for and awareness of our restaurants. We cannot assure you, however, that our service marks:

- do not or will not violate the proprietary rights of others;
- would be upheld if challenged; or
- that we would not be prevented from using our service marks.

Any of these occurrences could materially adversely affect us. In addition, we cannot assure you that we will have the financial resources necessary to enforce or defend our service marks. We believe that we own all of our intellectual property and that the management and license agreements to which we are a party are enforceable. In the past, the enforceability of these management and license agreements has been questioned by certain of the licensees. Although we believe the agreements are enforceable, there can be no assurance that the agreements will not be challenged in the future, and, if challenged, that the agreements will be determined to be enforceable and the managed restaurants will be restricted from using the Shells service marks independent of us.

We also rely on trade secrets and proprietary knowledge. We employ various methods to protect our concepts and recipes. However, these methods may not completely protect us. We cannot assure you that others will not independently develop similar knowledge or obtain access to our knowledge, concepts and recipes. Although we generally enter into confidentiality agreements with our executives and managers, we cannot assure you that these agreements will adequately protect our trade secrets.

Our insurance coverage may not be adequate. We maintain insurance, including insurance relating to personal injury, in amounts, which we currently consider adequate. Nevertheless, a partially or completely uninsured claim against us, if successful, could materially adversely affect us.

We depend on key personnel. Our success is largely dependent upon our executive management and other key personnel. The loss of the services of one of our executives or other key personnel could materially adversely affect us. Our success may also depend on our ability to attract and retain qualified management restaurant industry personnel.

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Absence of Dividends. We have never paid cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. In addition, our debt financings prohibit the payment of cash dividends and any future financing agreements may also prohibit the payment of cash dividends.

Provisions with Potential Anti-Takeover Effect. Our certificate of incorporation provides that we may issue up to 2,000,000 shares of preferred stock from time-to-time in one or more series. The Board of Directors is authorized to determine the rights, preferences, privileges and restrictions granted to and imposed upon any wholly unissued series of preferred stock. The Board is authorized to fix the number of shares of any series of preferred stock and the designation of any such series, without any vote or action by our stockholders. The Board may authorize and issue preferred stock with voting, dividend, liquidation, conversion or other rights that could adversely affect the voting power or other rights of the holders of our common stock. In addition, the potential issuance of preferred stock may have the effect of delaying, deferring or preventing a change in control, may discourage bids for our common stock at a premium over the market price of the common stock and may adversely affect the market price of the common stock.

On October 24, 2001, the Company issued 66,862 shares of Series A 5% Convertible Preferred Stock, par value $0.01 per share (the Series A Preferred Stock), pursuant to an exemption from registration under Section 4(6) of the Securities Act of 1933, as amended, in consideration for the cancellation of $669,000 of trade indebtedness by trade creditors of the Company. We have no present intention to issue any additional shares of our preferred stock. However, we cannot assure you that we will not do so in the future.

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ITEM 2. PROPERTIES

We lease 6,800 square feet of space in Tampa, Florida for our executive offices. The annual rent payable under the lease, which expires October 31, 2004, is approximately $100,000. Discussions with the landlord are under way and we anticipate renewing the lease.

All but three of our existing restaurants in operation are leased properties. One owned property was sold during 2002. In the future, we intend to lease most of our properties but may from time-to-time acquire restaurant locations based on individual site evaluation. Each of our leases provides for a minimum annual rent and certain of these leases require additional rental payments to the extent sales volumes exceed specified amounts. Generally, we are required to pay the cost of insurance, taxes and a portion of the landlord s operating costs to maintain common areas. Restaurant leases have initial terms averaging 13 years and renewal options averaging 16 years, and rents averaging $15.00 per square foot.

ITEM 3. 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. By court order, the parties reached a settlement arrangement in an August 2003 mediation whereby we paid the landlord $107,000 to terminate the lease and dismiss the lawsuit. A final settlement and disposition of this case occurred in December 2003.

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 purse collection of this judgment.

The State of Indiana filed liens for unpaid taxes on tangible business property for the years 2000, 2001 and 2002 relating to two properties of restaurants we closed. The taxes were paid in March 2004 and the liens released.

On March 11, 2003, we received a notice from the Equal Employment Opportunity Commission (EEOC) that a former employee in our Miami store had dually filed a charge of discrimination with both the EEOC and the Florida Commission on Human Relations. Shells terminated the employment of this person in December 2002. Specifically, this former employee claimed gender discrimination and retaliation under Title VII of the Civil Rights Act of 1964 and age discrimination in violation of the Age Discrimination in Employment Act of 1967. The parties reached a settlement agreement which was finalized during December 2003.

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.

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ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SHAREHOLDERS

None.

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PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON STOCK AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the over-the-counter bulletin board under the symbol SHLL . The following table sets forth the high and low per share price of our common stock as reported by the OTC bulletin board.

These over-the-counter market quotations reflect inter-dealer prices, without retail markup, mark-down or commission and may not necessarily represent actual transactions.

Fiscal 2002	High	Low
First quarter	$ 0.65	$ 0.35
Second quarter	$ 0.65	$ 0.45
Third quarter	$ 1.00	$ 0.41
Fourth quarter	$ 0.58	$ 0.25
Fiscal 2003		
First quarter	$ 0.75	$ 0.35
Second quarter	$ 0.70	$ 0.40
Third quarter	$ 0.70	$ 0.51
Fourth quarter	$ 0.95	$ 0.42

The number of stockholders of record of our common stock on March 19, 2004 was approximately 250. The Company s stock price as of March 19, 2004 was $0.52.

Our authorized capital stock consists of 20,000,000 shares of common stock, par value $0.01 per share, and 2,000,000 shares of preferred stock, par value $0.01 per share.

Dividend Policy

We have never declared or paid any cash dividends on our common stock. All future earnings will be retained by us for the development of our business. Accordingly, we do not anticipate paying cash dividends on the common stock in the foreseeable future. We are subject to loan covenants containing certain provisions prohibiting our ability to pay dividends.

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Equity Compensation Plans

Securities authorized for issuance under equity compensation plans as of December 28, 2003 were as follows:

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights [a]	Weighted-average exercise price of outstanding options, warrants and rights [b]	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column [a]) [c]
Equity compensation plans approved by security holders	2,941,000	$ 0.94	1,560,142
Equity compensation plans not approved by security holders	8,908,030	$ 0.16	
Total	11,849,030		1,560,142

Equity compensation plans not approved by security holders consist of warrants to purchase shares of common stock, issued on January 31, 2002, in connection with a $2,000,000 private financing transaction. The warrants, which may be exercised by a cashless exercise , have an exercise price of $0.16 per share and are exercisable through January 31, 2005.

The number of securities and type of plans available for future issuance of stock options as of December 28, 2003 was:

	Options for Common Shares:			
Plan Name	Authorized	Exercised	Outstanding	Available
Stock Option Plan for Non-Employee Directors	150,000	0	36,000	114,000
1995 Employee Stock Option Plan	840,000	0	266,217	573,783
1996 Employee Stock Option Plan	101,000	11,001	31,992	58,007

2002 Equity Incentive Plan	1,850,000	160,790	874,858	814,352
Total	2,941,000			