

Fellow Shareholders and Other Stakeholders:

2004 was another year of strong performance for our Company on most fronts, but it certainly had its challenges. Net sales increased 14.8 percent to \$122,918,000. About 2 percent of this increase was the result of an extra week in our fiscal year (as well as the fourth quarter), which happens every five or six years. Last year we included a table with additional income statement captions (in the bold face) to help explain our performance. This year the table has been expanded to three fiscal years and it will be augmented with some additional information to give a better picture of how we review our performance.

A casual reader of our financial statements might note that our income before income taxes increased 103 percent over 2003, but we do not assess our 2004 business performance to be nearly that good. Nor do we consider our performance to be even as good as the 47 percent improvement in net income.

J. Alexander's Corporation Historical Results

	Fiscal Years			2004 vs. 2003 +/- %
	2002	2003	2004	
Net sales	\$98,779	\$107,059	\$122,918	15%
Restaurant operating expenses	87,065	93,751	107,985	15%
Restaurant operating income	11,714	13,308	14,933	12%
General and administrative expenses	7,844	8,220	8,568	4%
Operating income before pre-opening expense and involuntary conversion gain ("Running the business profit")	3,870	5,088	6,365	25%
Pre-opening expense	10	897	-	-100%
Involuntary property conversion gain	-	-	117	-
Operating income	3,860	4,191	6,482	55%
Total other expense (principally interest)	1,252	2,033	2,104	3%
Income before income taxes and cumulative effect of change in accounting principle	2,608	2,158	4,378	103%
Income tax benefit	398	1,122	444	-60%
Cumulative effect of change in accounting principle	(171)	-	-	-
Net income	\$ 2,835	\$ 3,280	\$ 4,822	47%

"Restaurant operating income" does not include the following expenses: general and administrative, pre-opening costs, interest and all other items not directly related to the "under roof" performance of our restaurants. Depreciation, on the other hand, which is a significant "under roof" expense, is included in restaurant operating expenses.

Our restaurant operating income increased about 12 percent, slightly less than our revenue increase. This is not a good result, and I would normally expect much higher performance in this area. Cutting to the chase, our input (mainly food) costs were unusually high in 2004 and the losses of our two newest restaurants were substantially higher than we expected. More on those later.

We did a good job of controlling general and administrative expenses in 2004, which increased about 4 percent for the year. Excluding non-cash stock option compensation expense, the increase was about 12 percent computed as follows:

	Fiscal Years		
	2003	2004	+/- %
General and administrative expenses as reported	\$8,220	\$8,568	4%
Deduct non-cash stock option compensation expense	(552)	(18)	-97%
General and administrative expenses as adjusted	\$7,668	\$8,550	12%

Our "running the business profit", as we refer to it internally – or operating income before pre-opening expenses (and, in 2004, before a gain on an involuntary conversion of property) – which is also highlighted in the table, increased 25 percent. This is a solid result, especially when one considers that in 2003 we had a 31 percent increase in operating income before pre-opening expenses over 2002. I was delighted with the 31

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percent increase last year and commented in last year's letter that it would be difficult to achieve the same level again in 2004. Nevertheless, a 25 percent increase on a 15 percent increase in revenue is a long way from disappointing.

Our "running the business profit" is one of the key internal measures we use to determine how well our business is performing. It is an internal measure of efficiency we use in managing our restaurants, but it does not include three significant expenses: interest, pre-opening costs, and income taxes. We believe our increase in "running the business profit" is representative of our performance this year.

For several years I have discussed the next line item in the table, pre-opening expense. These are real expenses but they vary all over the block and can disappear in a year when we do not open a new restaurant, such as 2004. Normally, expenses should be matched to the revenues they produce, but pre-opening expenses are an exception. They are expensed before any revenue is generated. The fact that we had no pre-opening costs in 2004 contributed significantly to our impressive, but unrepresentative 55 percent improvement in operating income. We did not do that well. We also had a small gain on an involuntary property conversion (the condemnation of a portion of our Denver restaurant site for mass transit purposes) that increased operating income.

I do want to make one other accounting comment. (That's what ex-accountants do; you are lucky I am not an actuary or proctologist.) Part of the big difference in our pre-tax and after-tax income is caused by changes in the valuation allowance associated with our deferred tax assets. As of January 2, 2005 we had net deferred tax assets of approximately \$6.5 million, which are composed primarily of tax credit carryforwards that are available to reduce our future federal income taxes. Under generally accepted accounting principles, we are required (no choice) each year to make an estimate of the likelihood of having taxable income in future periods sufficient to use those credits to offset future income taxes.

Based on our assessment at the end of 2003 we increased the net tax assets on our books by \$1,475,000 and recorded an income tax benefit in a corresponding amount. In 2004 our net tax assets increased by an additional \$1,888,000, which included an adjustment to the beginning of the year valuation allowance of \$1,531,000 that similarly increased our income tax benefit. Changes in the valuation allowance are not part of what we consider when we evaluate the performance of our business. We do sometimes "normalize" our income taxes and earnings for purposes of comparing our performance to other companies by reducing pre-tax income by an assumed income tax rate which we believe would be representative for restaurant companies. We believe this is a reasonable approach.

Earlier I mentioned my disappointment in the improvement in our restaurant operating income in 2004 as compared to 2003. On a revenue increase of 15 percent, including a higher-than-expected increase in weekly average same store sales of 7.9 percent, I would expect an increase in restaurant operating income of 18 or 19 percent. Two factors torpedoed that expectation in 2004. First, input costs, especially in the food area, increased by record amounts, and the related increase in our cost of sales was the largest I have seen since I have been in the restaurant business. Our beef prices increased by almost 13 percent in 2004 in part because we had a favorable contract in 2003. Beef purchases alone account for approximately one-third of our total food purchases. Additionally, poultry markets were near record levels for much of the year, as were dairy and many other produce items. (As if high prices weren't enough, we also experienced some shortages and poor quality, especially for tomatoes.) The result was that our cost of sales shot up from 32.4 percent of sales in fiscal year 2003 to 33.6 percent last year, even after we implemented about a 5 percent menu price increase in most of our restaurants. We would have needed over a 10 percent price increase to hold cost of sales at the 2003 level. While we gave some consideration to such an aggressive increase, we just didn't have the stomach for it.

The other negative factor which held down our 2004 results was the unexpectedly poor performance of our two newest restaurants, which posted significant operating losses for the year. Late in 2004, their sales started to improve. That improvement has continued

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Steak Frites

A French bistro classic. A heavily seasoned Certified Angus Beef® strip steak with Maitre D'Hotel butter and served with french fries.



so far in 2005, and our outlook is for significant improvement this year. While the early volumes of our new restaurants can show a wide variance, the 2004 sales performance in our two newest restaurants was just plain disappointing.

Overall, our guest counts for the year remained positive in 2004. More specifically, we had good growth in guest counts during the first half of the year and saw expected reductions in the third and fourth quarters. We are expecting a small guest count loss during the first half of this year as well.

Restaurant labor and related costs declined from 32.7 percent of sales in 2003 to 31.4 percent in 2004. Most of this decline resulted from our increase in weekly average sales, which was driven by the performance of our mature restaurants discussed in more detail below. Even with this significant increase in sales, our total restaurant operating expenses, which include cost of sales, labor, depreciation, and other operating expenses remained roughly the same at 87.9 percent of sales in 2004, compared with the 87.6 percent in 2003. Said another way, our restaurant operating income margin, before general and administrative and other costs, declined slightly, from 12.4 percent of sales to 12.1 percent of sales.

The last area I would like to discuss involves significant achievements posted by our 24 mature restaurants. Five crossed, or were very near, the \$6 million mark in sales (aided somewhat by 2004 being a 53-week year). Ten posted a weekly average sales increase in excess of 10 percent.

Another non-GAAP number we use in our internal evaluations is “profit before occupancy costs” (also called “restaurant level controllable income”), which is computed by subtracting from sales the cost of sales, labor, benefits, and certain restaurant operating expenses. (This measure excludes depreciation, rents, and certain other occupancy costs.) Since our investment varies in each of our restaurants and the financial structure of each location is somewhat different, this is our level-playing-field benchmark and is a big component of the bonus system for our coaches. It is an important measurement of our internal management efficiencies.

Six of the 24 mature restaurants had declines in profit before occupancy from 2003, although only three were significant enough to merit aggressive action. You might think our batting average of .750 is good, but we expect improvement in all 24. It is never acceptable to have a restaurant post a decline in profit before occupancy. Because of the highly competitive nature of our business, competitive intrusion sometimes does take a temporary toll on one of our restaurants, but more often declines in controllable income are self-inflicted. We react very aggressively to any weakness in this metric.

A key component within profit before occupancy is gross margin, another non-GAAP term. We define gross margin as net sales less cost of sales and direct restaurant labor as set forth and reconciled to operating income in the following table:

<i>(Dollars in 000's)</i>	Fiscal Years		
	2003	2004	% Increase
Net sales	\$107,059	\$122,918	15%
Cost of sales	34,732	41,324	19%
(as a percentage of net sales)	32.4%	33.6%	
Direct restaurant labor costs	27,844	30,945	11%
(as a percentage of net sales)	26.0%	25.2%	
Gross margin	44,483	50,649	14%
(as a percentage of net sales)	41.5%	41.2%	
Labor related costs	7,187	7,652	
Depreciation and amortization of restaurant property and equipment	4,337	4,670	
Other restaurant operating expenses	19,651	23,394	
General and administrative expenses	8,220	8,568	
Pre-opening expense	897	–	
Gain on involuntary property conversion	–	117	
Operating income	\$ 4,191	\$ 6,482	

Our total restaurant operating expenses, which include cost of sales, labor, depreciation, and other operating expenses remained roughly the same at 87.9 percent of sales in 2004, compared with the 87.6 percent in 2003.

Prime Rib of Beef

Certified Angus Beef[®], slow roasted, served au jus with smashed potatoes.



In our view, direct restaurant labor includes both management and hourly labor, but excludes benefits because they are somewhat fixed in nature and we consider them as an operating expense. We think that improving gross margin is key to improving profitability.

Much of my thinking about management accounting is based on the concept of direct cost and contribution accounting. Dr. Germain B. Böer, currently professor of accounting at Owen Graduate School of Management at Vanderbilt University, in his introduction to *Direct Cost and Contribution Accounting* (this book is 100 percent non-GAAP), published in 1973, wrote that “The most significant development in management accounting methodology in the last 30 years is the application of direct costing concepts to management planning and control problems.”

The restaurant industry is an ideal area to utilize the methods outlined in Dr. Böer’s textbook, which I have always considered to be the global standard for any dialogue on direct costing. At the core of any restaurant concept is its ability to generate margin dollars. Employee benefits, operating expenses, depreciation, and interest may have some slight variable component, but all are generally fixed in nature. We could note that utility costs would increase if a restaurant serves 5,000 guests a week instead of 4,000, but if it served only one guest its heating and air conditioning system would be operating, the lights would be on, and all cooking equipment would be powered up and ready to go. Thus, a significant portion of utility costs is fixed.

This same argument could be made about management labor. Hourly labor is somewhat more variable. The most variable cost in a restaurant is cost of sales. While cost of sales dollars increase or decrease based on guest counts, cost of sales as a percentage of sales hardly varies at all unless there is a change in product mix or some other dynamic inside the restaurant.

When input costs increase, cost of sales dollars go up and the cost of sales percentage increases accordingly, with a corresponding shrink in margins. In businesses like restaurants that employ a high level of fixed costs, a small change in variable costs can cause margins to shrink or grow disproportionately. The wonderful thing about this formula is that when revenues increase, say by selling 6 desserts for every 100 guests instead of 3 desserts for every 100 guests, the cost of sales percentage may stay the same, but the ramp up in sales dollars assuming a 33 percent cost of sales allows for almost \$0.67 on every dollar to flow through to pre-tax income.

Most of us in the restaurant industry are margin obsessed. By increasing gross margins ever so slightly, we can flow through or increase significantly pre-tax earnings. This is what makes the concept of direct costing so fascinating and why it is applicable to the restaurant industry.

As I commented above, our input costs increased significantly in the cost of sales area, and we were unwilling to try to offset them totally by price increases. In a normal environment, an increase of almost 8 percent in comparable unit sales would have increased earnings by an exponential amount because a significant amount of our costs are fixed or semi-fixed in nature.

One of our objectives over the next several years will be to bring our cost of sales down to a maximum of 31 percent and thereby significantly increase our gross margin – please don’t think this will be easy. We plan to do this by making some changes in our pricing strategy, continuing to work on efficiencies in production, and reducing cost of sales by menu consolidation. We will also utilize creative feature products which have lower food costs than some of our more popular dinner oriented entrées.

Our outlook for 2005 in the cost area is mixed. The current consensus view is that poultry and dairy costs should stabilize or decline in 2005. Because we use 100 percent fresh poultry at J. Alexander’s, we are unable to obtain a contract or a hedge at an acceptable cost on the fresh poultry market. I expect more and more restaurant companies will begin to use frozen poultry to eliminate some of the input cost risk. Because we believe so strongly that quality is a critical business driver of our concept,

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Black Drum

Hardwood-grilled filets of Black Drum on a bed of Louisiana rice finished with J. Alexander’s Czarina sauce.



we simply will not use frozen poultry. This market needs to decline for the entire year to benefit us.

Our fixed price beef contract will increase 7 to 8 percent this year, about a quarter of which is the result of our decision to convert our entire beef program (the subject of this year's last dissertation is beef) to Certified Angus Beef® brand.

The three top grades of beef in the United States are Prime, Choice, and Select (as graded by the United States Department of Agriculture or U.S.D.A.). Prime accounts for only two percent of all graded beef, Choice a little over 50 percent, and Select the balance. The biggest buyers of Select beef have historically been grocery stores, while restaurants have generally bought Prime and Choice. There is a huge variance in the Choice grade, based on the amount of marbling in the beef (the higher the level of marbling the higher the grade). We have always sought U.S.D.A. Choice beef with the most abundant marbling. Working with our primary beef supplier, we have been able to buy at the top end of the Choice grade or "Top Choice". Top Choice is an industry term, not a U.S.D.A. term (which is something like GAAP for beef; forgive me). In recent years more and more beef packers have developed their own Top Choice programs, which they call "Premium" beef. (Sometimes I think their purpose is to confuse consumers; "Premium" is not "Prime".) Each major meat packer now has a Premium beef brand, and it has become harder and harder for us to buy the top Choice when we are competing with beef processors, who want that for their own branded Premium products.

J. Alexander's number one business driver is quality. Our marketing research has indicated that we have a strong leadership position in quality, compared to our direct competitors. It has always been one of the key legs on which our reputation stands. We simply must provide our guest with a top-quality product, especially in the important beef category.

In our opinion, Certified Angus Beef® is the best of the Premium products. It includes only the top 8 percent of all graded beef in the United States. "CAB" as it is usually referred to is priced at a premium to the rest of the top end of Choice, but below U.S.D.A. Prime beef. For the 2005 contract year, the price of the Choice market bumped up close to the CAB market, and we decided it was the right time to convert to 100 percent CAB. Many of you have heard the word "Angus" used in a host of grocery store promotions, as well as the ads of quick service and other restaurants. All Angus is not the same. In the United States a cow that is predominately black, lacks a hump and does not have floppy ears can be classified as Angus. (So far, you can rest assured that it absolutely must be a cow.) The CAB grading standard is much higher; only twenty percent of Angus-style cattle qualify as CAB. We believe it is an incredible product and we are excited about upgrading our beef program.

This product will represent higher value for our guests, and we will pass along also a substantial portion of its cost. One way we plan to do this and also ease any perception of pain is by changing our pricing structure to a modified à la carte system. J. Alexander's is one of the few upscale restaurants that has automatically included a salad with most of our beef and seafood entrées. As many of you have experienced, our vegetable and other side item portions are quite generous. We have decided to price our beef and seafood entrées with only a side item included in the menu price. For a small charge, our guests can, of course, add a salad. This change should allow us to keep our entrée pricing for CAB beef and premium seafood in the mid \$20 range. We have historically sold several entrées without salads ("unbundled," as we internally refer to it), but prime rib, steaks, and premium seafood items have always been "bundled" with a salad. We believe the upgrade in our beef quality will continue to drive our sales and that this change in pricing strategy will help attain our goal of lowering our cost of sales.

J. Alexander's core business strategy has always centered around providing our guests with the highest available quality product in casual dining, supported by attentive professional service in a unique upscale dining environment. We serve generous portions

We simply must provide our guest with a top-quality product, especially in the important beef category.

Filet

A ten-ounce center cut Certified Angus Beef® filet served with Maitre D'Hotel butter and a loaded one-pound baked potato.



of high-quality food. Our restaurants have an upscale, tasteful, classic ambiance. The ambiance of the restaurants, together with our high-quality food, and intensely attentive, professional service, are the three key business drivers of our concept. Even though our restaurants are large by some standards (42 tables on average), we still strive to create an environment that is conducive to highly personalized service. The casual dining industry, more specifically its upscale segment, is occupied by a large number of good concepts. Virtually every one either claims or aspires to be the best upscale casual dining restaurant in the industry. This tough competition forces good restaurants to constantly fine tune their menus, enhance guest service, maintain their physical plant in first quality condition, and reinvent themselves to stay aligned with upscale consumers and compete for their loyalty. We believe that we successfully answer this challenge and thrive in this environment. We have an outstanding management team and a committed group of champions that believe in our business principles. We are committed to quality in all that we do.

Our senior management team recently studied *Execution*, by Larry Bossidy and Ram Charan. One of its points is that unsuccessful businesses are usually assumed to fail because of faulty strategy. The authors suggest that, to the contrary, most such companies had well-reasoned and reasonable strategies but failed because they did not develop a leadership team who could execute the strategy. At J. Alexander's, execution is what we are all about. We do not seek to be the largest restaurant company in the world or to be multi-branded. We seek to be recognized as the expert in execution of an excellent concept and to be the leader in operational excellence in our segment of the restaurant industry. It is an ambitious goal, but we continue to be committed to achieving it.

Last year I noted that we opened three restaurants in 2003, for us a major physical expansion. While we were willing to open another restaurant in 2004, it was not a high priority and we did not open one. We have under contract, for opening this year, a restaurant in our home market of Nashville on West End Avenue. We believe the West End corridor is one of the strongest markets in the southeastern United States.

We intend to open two units per year starting in 2006, assuming we find acceptable locations on acceptable terms. We will not open new restaurants just for the sake of doing so. Some of our new restaurants (including unfortunately our last two) have been painfully slow in building sales and we have decided to minimize our site risk in the future. Historically, we have sometimes opened in emerging areas to take advantage of what we believed would be good long-term sites. An example would be our restaurant in Overland Park, Kansas, which we built after the commitment that Sprint's worldwide headquarters would be built behind the restaurant. We were sure that within five to ten years the market would move our way. While we proved to be correct, for the first two to three years our sales were very soft. Now Overland Park is one of our best performing restaurants. Another example is our newest restaurant in Chicago, which is near but not in Lincoln Park. Retail development in the immediate area of this restaurant has so far been slow, and we have suffered.

We have also developed restaurants in small markets that opened at very low volumes and caused us to despair temporarily. While we have not formally modified our ideas about avoiding new restaurants in small markets, I have to admit that some of our best sales and profit growth in the last three years have been in some of those very restaurants. If we can develop a satisfactory, lower investment building for such markets, we might reconsider some small and mid market development in the future, but nothing is on the table at this time.

For 2006, we are focusing our development goals on locations in mature upscale markets with all the components already in place to help drive our business. We may miss an opportunity or two by not pioneering areas but believe that our next two or three openings will be a lot smoother in mature trade areas.

I am sure most of you are familiar with Section 404 of the Sarbanes-Oxley Act (SOX), which requires that public companies complete extensive documentation and

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Pork Tenderloin

Maple-cured pork tenderloin, hardwood grilled, finished with our own Thai-style bang-bang sauce and served with smashed potatoes.

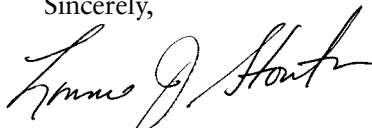
testing of their internal control systems. A few months ago we thought we would have to comply with Section 404 this year. The Securities and Exchange Commission has granted a reprieve for small companies such as us, and at the moment it will not be necessary for us to comply with SOX Section 404 until 2006. In its 2004 Annual Report, GE noted that it had cost \$33 million to comply with SOX. We cannot yet quantify our cost to comply with Section 404, but the initial cost could be as much as \$500,000, which is 11 percent of our 2004 pre-tax earnings. We believe that is a huge cost for our owners to bear to comply with SOX 404. We are hopeful (praying would be a better word) that small cap companies will be granted some permanent relief from SOX 404. Many of you know that I am an advocate for high standards, the higher the better. However, this level of cost to comply with SOX appears excessive for the smaller public companies. (If GE spent 11 percent of their pre-tax earnings, SOX would have cost them \$2.2 billion.)

We are looking forward to another year of continuous improvement, realizing that 2005 will be a 52-week year, compared to the 53 weeks of 2004. Another headwind is that we will experience pre-opening costs for our new West End restaurant, compared to none in 2004. We expect our same store sales growth to continue to be solid. We believe our new beef program and modified à la carte pricing will also help improve our profitability in 2005.

Our management team continues to get better and will always need to improve. We will spend more time this year on internal management development. We believe the best way to build a great company is to ensure that we have an excellent management organization dedicated to superior execution. I want to thank all of our coaches, champions, operational leadership team, and the corporate support center staff for their dedication and hard work in creating and sustaining one of the best businesses in the upscale casual dining industry.

As always, we are deeply indebted to you our shareholders, especially our long-term investors, for your continuing support and the confidence you have placed in this management team and our restaurant concept. On behalf of all the team at J. Alexander's, we promise to work hard for you again this year and to do our very best to continue to improve our performance in all categories.

Sincerely,



Lonnie J. Stout II
Chairman, President and Chief Executive Officer
April 3, 2005

We believe the best way to build a great company is to ensure that we have an excellent management organization dedicated to superior execution.