

1 800 CONTACTS INC
Form 10-Q
November 12, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark one)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended October 2, 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 number: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

Delaware

87-0571643
(I.R.S. Employer Identification No.)

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(State or other jurisdiction of
incorporation or organization)

**66 E. Wadsworth Park Drive,
Draper, UT**
(Address of principal executive offices)

84020
(Zip Code)

(801) 924-9800
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes

No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange act).

Yes

No

As of November 5, 2004, the Registrant had 13,288,593 shares of Common Stock, par value \$0.01 per share, outstanding.

1-800 CONTACTS, INC.

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PART 1. FINANCIAL INFORMATION**Item 1. Financial Statements****1-800 CONTACTS, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(in thousands)****(unaudited)****ASSETS**

	January 3, 2004	October 2, 2004
CURRENT ASSETS:		
Cash	\$ 1,075	\$ 373
Accounts receivable, net	944	1,638
Inventories, net	24,127	23,832
Prepaid income taxes	797	
Deferred income taxes	548	971
Other current assets	1,752	3,158
Total current assets	29,243	29,972
PROPERTY, PLANT AND EQUIPMENT, net	13,183	18,078
DEFERRED INCOME TAXES	710	723
GOODWILL	33,853	33,937
DEFINITE-LIVED INTANGIBLE ASSETS, net	9,207	18,400
OTHER ASSETS	735	1,070
Total assets	\$ 86,931	\$ 102,180
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Current portion of long-term debt	\$ 3,381	\$ 1,426
Current portion of capital lease obligations	191	108
Accounts payable	8,558	7,721
Accrued liabilities	4,847	9,618
Total current liabilities	16,977	18,873
LONG-TERM LIABILITIES:		
Line of credit		16,351
Long-term debt, less current portion	14,683	8,295
Capital lease obligations, less current portion	64	54
Deferred income tax liabilities		2,071
Total long-term liabilities	14,747	26,771
STOCKHOLDERS EQUITY		
Common stock, 13,113 and 13,288 issued, respectively	131	133
Additional paid-in capital	42,346	45,799
Retained earnings	12,834	10,833
Accumulated other comprehensive loss	(104)	(229)
Total stockholders equity	55,207	56,536
Total liabilities and stockholders equity	\$ 86,931	\$ 102,180

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See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(in thousands, except per share amounts)

(unaudited)

	Quarter Ended		Three Quarters Ended	
	September 27, 2003	October 2, 2004	September 27, 2003	October 2, 2004
NET SALES	\$ 48,400	\$ 56,893	\$ 141,416	\$ 157,713
COST OF GOODS SOLD	29,489	34,889	88,629	97,140
Gross profit	18,911	22,004	52,787	60,573
OPERATING EXPENSES:				
Advertising	7,171	6,533	14,551	22,572
Legal and professional	1,601	1,026	4,977	4,207
Research and development	777	567	2,777	1,902
Purchased in-process research and development				83
Other operating	9,316	10,789	28,069	31,437
Total operating expenses	18,865	18,915	50,374	60,201
INCOME FROM OPERATIONS	46	3,089	2,413	372
OTHER EXPENSE, net	(161)	(216)	(984)	(1,271)
INCOME (LOSS) BEFORE PROVISION FOR INCOME TAXES	(115)	2,873	1,429	(899)
PROVISION FOR INCOME TAXES	(513)	(1,520)	(1,985)	(1,102)
NET INCOME (LOSS)	\$ (628)	\$ 1,353	\$ (556)	\$ (2,001)
PER SHARE INFORMATION:				
Basic and diluted net income (loss) per common share	\$ (0.05)	\$ 0.10	\$ (0.04)	\$ (0.15)

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(in thousands)

(unaudited)

	Three Quarters Ended	
	September 27, 2003	October 2, 2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (556)	\$ (2,001)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization	4,617	5,630
Amortization of debt issuance costs and discounts	142	247
Amortization of restricted stock grant		8
Purchased in-process research and development		83
Unrealized foreign currency exchange (gain) loss	(46)	27
Loss on sale of property and equipment	7	89
Stock-based compensation	731	
Deferred income taxes, net of effects of acquisition	(206)	(1,439)
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable, net	(554)	(671)
Inventories, net	10,815	695
Other current assets	(242)	(1,110)
Accounts payable	(3,554)	(1,621)
Accrued liabilities	1,969	2,856
Income taxes payable / prepaid income taxes	1,611	2,170
Net cash provided by operating activities	14,734	4,963
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of property and equipment	(2,138)	(5,996)
Proceeds from sale of property and equipment	33	3
Purchase of intangible assets	(85)	(3,997)
Cash paid for acquisitions	(7,012)	(3,776)
Deposits and other	(316)	(289)
Net cash used in investing activities	\$ (9,518)	\$ (14,055)

1-800 CONTACTS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)

(in thousands)

(unaudited)

	Three Quarters Ended	
	September 27, 2003	October 2, 2004
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from exercise of common stock options	\$ 803	\$ 159
Proceeds from international government grant		873
Net (repayments) borrowings on line of credit	(3,242)	16,351
Debt issuance costs		(196)
Principal payments on capital lease obligations	(294)	(219)
Principal payments on long-term debt	(1,891)	(8,511)
Net cash (used in) provided by financing activities	(4,624)	8,457
EFFECT OF FOREIGN EXCHANGE RATES ON CASH	(32)	(67)
NET INCREASE (DECREASE) IN CASH	560	(702)
CASH AT BEGINNING OF PERIOD	259	1,075
CASH AT END OF PERIOD	\$ 819	\$ 373
SUPPLEMENTAL CASH FLOW INFORMATION:		
Cash paid for interest	\$ 821	\$ 964
Cash paid for income taxes	580	370

SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING AND FINANCING ACTIVITIES:

During the first quarter of 2003, the Company purchased certain assets and assumed certain liabilities of Lens Express and Lens 1st. The purchase consideration included cash of \$7,012, common stock with a fair value of \$19,859 and assumed operating liabilities of \$4,099.

During the second quarter of 2003, the performance guarantee was met relating to 700,000 shares of the Company's restricted common stock held in escrow as partial consideration for the July 2002 acquisition of ClearLab. The Company recorded additional purchase consideration of approximately \$16,980 for these shares. The Company recorded this as goodwill, net of a contingent consideration liability recorded at the purchase date. The amount of goodwill as of September 27, 2003 was \$11,205.

During the first quarter of 2004, the Company purchased the stock of VisionTec (subsequently renamed ClearLab UK, Ltd.). The purchase consideration included cash of \$3,776 and common stock with a fair value of \$3,200 (see Note 6).

See accompanying notes to condensed consolidated financial statements.

1-800 CONTACTS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1. PRESENTATION OF CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to such rules and regulations. These condensed consolidated financial statements reflect all adjustments (consisting only of normal recurring adjustments), which in the opinion of management, are necessary to present fairly the results of operations of the Company for the periods presented. It is suggested that these condensed consolidated financial statements be read in conjunction with the audited financial statements and the notes thereto included in the Company's Annual Report on Form 10-K for the year ended January 3, 2004.

NOTE 2. INVENTORIES

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Inventories are recorded at the lower of cost (using the first-in, first-out method) or market value. Inventories consisted of the following (in thousands):

	January 3, 2004		October 2, 2004
Purchased contact lenses	\$ 20,943	\$	18,618
Manufactured inventories:			
Raw materials	429		664
Work in process	2,681		4,394
Finished goods contact lenses	74		156
Total	\$ 24,127	\$	23,832

Provision is made to reduce excess and obsolete inventories to their estimated net realizable values. As of January 3, 2004 and October 2, 2004, reserves for excess and obsolete inventories were \$623,000 and \$1,072,000, respectively.

NOTE 3. NET INCOME (LOSS) PER COMMON SHARE

Basic net income (loss) per common share (Basic EPS) excludes dilution and is computed by dividing net income (loss) by the weighted-average number of common shares outstanding during the period. Diluted net income (loss) per common share (Diluted EPS) reflects the potential dilution that could occur if stock options or other common stock equivalents were exercised or converted into common stock. The computation of Diluted EPS does not assume exercise or conversion of securities that would have an antidilutive effect on net income (loss) per common share. For the quarter and three quarters ended October 2, 2004, options to purchase 956,071 and 1,257,476 shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive. For the quarter and three quarters ended September 27, 2003, options to purchase 686,852 and 835,261, shares of common stock, respectively, were not included in the computation of Diluted EPS because the effect would be antidilutive.

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The following is a reconciliation of the numerator and denominator used to calculate Basic and Diluted EPS (in thousands, except per share amounts):

	Quarter Ended September 27, 2003			Quarter Ended October 2, 2004		
	Net Loss	Shares	Per-Share Amount	Net Income	Shares	Per-Share Amount
Basic EPS	\$ (628)	13,103	\$ (0.05)	\$ 1,353	13,287	\$ 0.10
Effect of stock options					86	
Diluted EPS	\$ (628)	13,103	\$ (0.05)	\$ 1,353	13,373	\$ 0.10

	Three Quarters Ended September 27, 2003			Three Quarters Ended October 2, 2004		
	Net Loss	Shares	Per-Share Amount	Net Loss	Shares	Per-Share Amount
Basic EPS	\$ (556)	12,547	\$ (0.04)	\$ (2,001)	13,254	\$ (0.15)
Effect of stock options						
Diluted EPS	\$ (556)	12,547	\$ (0.04)	\$ (2,001)	13,254	\$ (0.15)

NOTE 4. COMPREHENSIVE INCOME (LOSS)

Comprehensive income (loss) for the quarter and three quarters ended September 27, 2003 and October 2, 2004 consists of the following components (in thousands):

	Quarter Ended		Three Quarters Ended	
	September 27, 2003	October 2, 2004	September 27, 2003	October 2, 2004
Net income (loss)	\$ (628)	\$ 1,353	\$ (556)	\$ (2,001)
Foreign currency translation	97	45	(205)	(125)
Comprehensive income (loss)	\$ (531)	\$ 1,398	\$ (761)	\$ (2,126)

The foreign currency translation results primarily from changes in exchange rates relative to the U.S. dollar from the translation of the Company's Singapore and United Kingdom subsidiaries' financial statements.

NOTE 5. STOCK-BASED COMPENSATION

The Company applies Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations and uses the intrinsic method of accounting for its stock option grants to employees and directors. No compensation expense has been recognized for stock option awards granted at or above fair market value of the stock on the date of grant.

Under Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation, compensation expense is recognized for the fair market value of each option as estimated on the date of grant using the Black-Scholes option-pricing model. SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure, amends SFAS No. 123, to provide alternative methods of

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transition for a voluntary change to the fair market value based method of accounting for stock-based employee compensation. In addition, SFAS No. 148 amends the disclosure requirements of SFAS No. 123 to require new prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The Company has elected to adopt the disclosure only provisions of SFAS No. 148.

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If compensation expense for all stock options had been determined consistent with SFAS No. 123, the Company's net income (loss) and basic and diluted net income (loss) per common share would have been as follows (in thousands, except per share amounts):

	Quarter Ended	
	September 27, 2003	October 2, 2004
Net income (loss):		
As reported	\$ (628)	\$ 1,353
Fair-value based compensation, net of tax	(382)	(380)
Pro forma	\$ (1,010)	\$ 973
Basic and diluted net income(loss) per common share:		
As reported	\$ (0.05)	\$ 0.10
Pro forma	\$ (0.08)	\$ 0.07

	Three Quarters Ended	
	September 27, 2003	October 2, 2004
Net loss:		
As reported	\$ (556)	\$ (2,001)
Fair-value based compensation, net of tax	(921)	(1,208)
Pro forma	\$ (1,477)	\$ (3,209)
Basic and diluted net loss per common share:		
As reported	\$ (0.04)	\$ (0.15)
Pro forma	\$ (0.12)	\$ (0.24)

The weighted average per share fair value of options granted during the quarters ended September 27, 2003 and October 2, 2004 and the three quarters ended September 27, 2003 and October 2, 2004 was \$14.07 and \$6.77, and \$13.92 and \$11.69, respectively. The fair value of each option grant has been estimated on the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Quarter Ended		Three Quarters Ended	
	September 27, 2003	October 2, 2004	September 27, 2003	October 2, 2004
Risk-free interest rate	2.7%	3.6%	2.7%	3.2%
Expected dividend yield	0.0%	0.0%	0.0%	0.0%
Volatility	74.8%	65.9%	77.0%	67.6%
Expected life	5 years	5 years	5 years	5 years

NOTE 6. RECENT ACQUISITIONS

VisionTec (subsequently renamed ClearLab UK Ltd)

On March 13, 2003, the Company signed a letter of intent with VisionTec, a developer and manufacturer of contact lenses based in the United Kingdom, and certain of its shareholders. The Company agreed to pay VisionTec a non-refundable sum equal to \$1.5 million to be used by the

NOTE 2. INVENTORIES

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entity for research and development activities relating to contact lenses. Of the total, \$0.7 million was paid on March 14, 2003, and the remaining \$0.8 million was paid on June 13, 2003. In addition, the Company was granted a six-month option to either: (1) acquire all of the shares of common stock of the entity; or (2) acquire from the entity a worldwide license to manufacture, market, sell or otherwise use or exploit specific technology developed by the entity. As consideration for this option, the Company paid \$0.1 million to VisionTec on March 14, 2003. In the event that the Company did not exercise the option to purchase the shares of VisionTec, the Company agreed to pay the entity an additional \$0.8 million. The Company

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also reimbursed VisionTec and its shareholders approximately \$0.2 million for legal and financial expenses incurred by the entity in connection with the agreement.

On September 12, 2003, the Company exercised the option to acquire all of the shares of common stock of VisionTec. During the period between September 12, 2003 and the closing of the acquisition on February 24, 2004, the Company continued to pay certain fees and expenses of the entity related to the entity's research and development activities. The Company paid approximately \$2.1 million to VisionTec from September 12, 2003 through January 3, 2004 and \$0.5 million from January 3, 2004 through February 24, 2004, for such research and development activities.

In connection with the agreement, and the transactions discussed above, the Company expensed a total of approximately \$3.9 million from March 13, 2003 through January 3, 2004 (inclusive of the \$0.2 million in reimbursed costs) related to these research and development initiatives and \$0.5 million in the first quarter of fiscal 2004 ended April 3, 2004.

On February 24, 2004, the Company completed the acquisition of all of the outstanding stock of VisionTec (subsequently renamed ClearLab UK Ltd). The consideration paid included approximately \$3.8 million in cash (including \$0.6 million in transaction costs) and 155,084 shares of the Company's common stock with a fair value of approximately \$3.2 million. In addition, the Company has agreed to pay a per unit royalty on the sale of contact lenses to the former shareholders of VisionTec for a period of ten years.

The Company filed a registration statement with the Securities and Exchange Commission (SEC) covering the resale of the 155,084 shares by the former stockholders of VisionTec.

The following sets forth the consideration paid by the Company (in thousands, except share amounts):

Cash	\$	3,200
Restricted shares (155,084 shares at \$20.634 per share)		3,200
Acquisition expenses		576
Total purchase consideration	\$	6,976

The following table sets forth the preliminary allocation of the purchase price to the net tangible and intangible assets acquired (in thousands):

Current assets	\$	629
Property, equipment and other long-term assets		2,914
Core technologies		4,791
Patents		3,355
Purchased in-process research and development		83
Current liabilities		(1,523)
Deferred income tax liability		(3,273)
Total	\$	6,976

Core technologies and patents are definite-lived intangible assets that are being amortized over twelve years.

NOTE 7. COMMON STOCK TRANSACTIONS

During the three quarters ended October 2, 2004, employees exercised stock options to purchase 20,689 shares of common stock for a total of approximately \$158,733. The Company recorded an increase in additional paid-in capital of approximately \$87,415 as a result of the

NOTE 2. INVENTORIES

income tax benefit related to these stock option exercises.

During the three quarters ended October 2, 2004, the Company granted nonqualified stock options to purchase 137,478 shares of common stock to employees and directors of the Company. The exercise price of the options was \$22.00 per share, which was not less than the quoted fair market value at the grant date. The options vest equally over a four-year period and expire in five years.

On February 24, 2004, the Company completed the acquisition of ClearLab UK and issued 155,084 shares of the Company's common stock with a fair value of approximately \$3.2 million (see Note 6). The restricted stock was registered with the Securities and Exchange Commission (SEC) on Form S-3 effective June 18, 2004.

NOTE 8. DEBT OBLIGATIONS

Effective February 27, 2004 and modified on June 25, 2004, the Company executed a restated loan agreement with its existing