

SHOE PAVILION INC
Form 10-Q
May 17, 2005
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 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 April 2, 2005

OR

TRANSITION REPORT PURSUANT TO SECTION 13 or 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number 0-23669

SHOE PAVILION, INC.

(Exact name of Registrant as Specified in its Charter)

Delaware
(State or Other Jurisdiction of Incorporation)

94-3289691
(IRS Employer)

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or Organization)

Identification Number)

1380 Fitzgerald Drive, Pinole, California 94564

(Address of principal executive offices) (Zip Code)

(510) 222-4405

(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

Indicate the number of shares outstanding of each of the issuer's classes of Common Stock, as of the latest practicable date.

As of April 30, 2005 the Registrant had 6,803,521 shares of Common Stock outstanding.

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This Quarterly Report on Form 10-Q contains certain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 which provides a safe harbor for these types of statements. These forward-looking statements are subject to risks and uncertainties and the Company's actual results could differ materially from management's current expectations. These factors include, without limitation, competitive pressures in the footwear industry, changes in the level of consumer spending on or preferences in footwear merchandise, economic and other factors affecting retail market conditions, the Company's ability to purchase attractive name brand merchandise at reasonable discounts, the availability of desirable store locations as well as management's ability to negotiate acceptable lease terms and maintain supplier and business relationships and open new stores in a timely manner. Other risk factors are detailed in the Company's filings with the Securities and Exchange Commission. The Company assumes no obligation to update forward-looking statements.

SHOE PAVILION, INC.**INDEX TO FORM 10-Q**

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PART I
FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements.

The following financial statements and related financial information are filed as part of this report:

Shoe Pavilion, Inc.
Condensed Consolidated Balance Sheets
(Unaudited)

(In thousands, except share data)

| | April 2, 2005 | January 1, 2005 |
|--|--------------------------|----------------------------|
| | <u> </u> | <u> </u> |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash | \$ 1,275 | \$ 1,179 |
| Receivables | 260 | 131 |
| Inventories | 37,452 | 35,654 |
| Deferred income taxes | 718 | 718 |
| Prepaid expenses | 1,625 | 1,469 |
| | <u> </u> | <u> </u> |
| Total current assets | 41,330 | 39,151 |
| | <u> </u> | <u> </u> |
| Property and equipment, net | 2,946 | 3,032 |
| Deferred income taxes and other | 1,766 | 1,775 |
| | <u> </u> | <u> </u> |
| TOTAL | \$ 46,042 | \$ 43,958 |
| | <u> </u> | <u> </u> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| CURRENT LIABILITIES: | | |
| Borrowings under credit agreement | \$ 6,463 | \$ 6,612 |
| Accounts payable | 11,861 | 10,456 |
| Accrued expenses | 3,230 | 2,974 |
| | <u> </u> | <u> </u> |
| Total current liabilities | 21,554 | 20,042 |
| Deferred rent | 3,525 | 3,359 |
| Commitments and contingencies | | |

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STOCKHOLDERS EQUITY:

| | | |
|--|-------------------|-------------------|
| Preferred stock - \$.001 par value; 1,000,000 shares authorized; no shares issued or outstanding | | |
| Common stock - \$.001 par value; 15,000,000 shares authorized; 6,801,021 shares issued and outstanding | 7 | 7 |
| Additional paid-in capital | 13,969 | 13,969 |
| Retained earnings | 6,987 | 6,581 |
| | <u> </u> | <u> </u> |
| Total stockholders equity | 20,963 | 20,557 |
| | <u> </u> | <u> </u> |
| TOTAL | \$ 46,042 | \$ 43,958 |
| | <u> </u> | <u> </u> |

See notes to condensed consolidated financial statements.

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Shoe Pavilion, Inc.
Condensed Consolidated Statements of Income
(Unaudited)

(In thousands, except per share and number of stores)

| | Quarter Ended | |
|--|------------------|------------------|
| | April 2, 2005 | April 3, 2004 |
| Net sales | \$ 23,299 | \$ 19,573 |
| Cost of sales and related occupancy expenses | 15,283 | 12,948 |
| Gross profit | 8,016 | 6,625 |
| Selling, general and administrative expenses | 7,234 | 5,969 |
| Income from operations | 782 | 656 |
| Interest expense | (111) | (72) |
| Income before income taxes | 671 | 584 |
| Income tax expense | (265) | (232) |
| Net income | \$ 406 | \$ 352 |
| Earnings per share: | | |
| Basic | \$ 0.06 | \$ 0.05 |
| Diluted | \$ 0.06 | \$ 0.05 |
| Weighted average shares outstanding: | | |
| Basic | 6,801 | 6,800 |
| Diluted | 7,054 | 6,816 |
| Stores operated at end of period | 85 | 85 |

See notes to condensed consolidated financial statements.

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Shoe Pavilion, Inc.

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)

| | Quarter Ended | |
|--|--------------------------|--------------------------|
| | April 2, 2005 | April 3, 2004 |
| Operating activities: | | |
| Net income | \$ 406 | \$ 352 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation and amortization | 328 | 353 |
| Asset impairment expense | | 57 |
| Loss on disposition of assets | | 6 |
| Effect of changes in: | | |
| Inventories | (1,798) | (3,227) |
| Receivables | (129) | 42 |
| Prepaid expenses and other | (165) | (223) |
| Accounts payable | 1,405 | 3,736 |
| Accrued expenses and deferred rent | 468 | 387 |
| Net cash provided by operating activities | 515 | 1,483 |
| Investing activities: | | |
| Purchase of property and equipment | (224) | (51) |
| Net cash used in investing activities | (224) | (51) |
| Financing activities: | | |
| Payments on credit facility, net | (149) | (1,270) |
| Principal payments on capital leases | (46) | (2) |
| Net cash used by financing activities | (195) | (1,272) |
| Net increase in cash | 96 | 160 |
| Cash, beginning of period | 1,179 | 1,034 |
| Cash, end of period | \$ 1,275 | \$ 1,194 |

See notes to condensed consolidated financial statements.

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Shoe Pavilion, Inc.

Notes to Condensed Consolidated Financial Statements

1. Basis of Presentation

General - The accompanying unaudited condensed consolidated financial statements have been prepared from the records of Shoe Pavilion, Inc. (the Company) without audit, and in the opinion of management, include all adjustments necessary to present fairly the financial position of the Company and the results of its operations and its cash flows for the periods presented. The balance sheet as of January 1, 2005 presented herein has been derived from the audited financial statements of the Company included in the Annual Report on Form 10-K for the year ended January 1, 2005.

The significant accounting policies followed by the Company are described in Note 2 to the audited consolidated financial statements for the year ended January 1, 2005. Certain information and footnote disclosures normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted for purposes of the condensed consolidated interim financial statements. The condensed consolidated financial statements included herein should be read in conjunction with the audited consolidated financial statements, including the notes thereto, for the year ended January 1, 2005.

The results of operations for the thirteen weeks ended April 2, 2005 presented herein are not necessarily indicative of the results to be expected for the full fiscal year.

Comprehensive Income and net income are the same.

Impairment of Long-Lived Assets - The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that their carrying value may not be recoverable. Management evaluates the carrying value of assets associated with stores which have been open at least 14 consecutive months. The Company records an impairment charge to write down the assets to their estimated fair value if the carrying values of such assets exceed their related expected future cash flows. The impairment charge is recorded in selling, general and administrative expenses. Management's estimates and assumptions used in the projections are subject to a high degree of judgment and if actual results differ, additional losses may be recorded. During the thirteen weeks ended April 3, 2004 the Company recorded an impairment charge of \$57,000 to write down assets in one store to its estimated fair value. No impairment charges were recorded during the thirteen weeks ended April 2, 2005.

Net Income Per Share Basic income per share is computed as net income divided by the weighted average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur from the exercise of outstanding stock options and is computed by dividing the net income by the weighted average number of common shares outstanding for the period plus the dilutive effect of outstanding stock options. The following table summarizes the incremental shares from these potentially dilutive securities, calculated using the treasury stock method.

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| | Thirteen weeks ended | |
|--|-----------------------------|--------------------------|
| | April 2, 2005 | April 3, 2004 |
| | (in thousands) | |
| Weighted average number of shares - basic | 6,801 | 6,800 |
| Add: effect of dilutive securities | 253 | 16 |
| Weighted average number of shares - diluted | 7,054 | 6,816 |

Excluded from the above computations of diluted net income per share are options to purchase 89,989 and 245,449 shares of common stock as of April 2, 2005 and April 3, 2004, respectively, as these shares were anti-dilutive.

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Stock-Based Compensation - The Company accounts for its stock option plans in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and its related interpretations. As the Company issues its options at fair value, no compensation expense has been recognized in the financial statements for stock option arrangements.

The following table illustrates the effect on net income and net income per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards (SFAS) No. 123, as amended by SFAS No. 148, *Accounting for Stock Based Compensation* .

| | Quarter Ended | |
|---|------------------|------------------|
| | April 2, 2005 | April 3, 2004 |
| Net income, as reported | \$ 406,000 | \$ 352,000 |
| Deduct stock-based compensation determined under fair value method, net of related tax benefits | (27,921) | (13,034) |
| Pro forma net income | \$ 378,079 | \$ 338,966 |
| Net income per share: | | |
| As reported: | | |
| Basic and diluted | \$ 0.06 | \$ 0.05 |
| Pro forma: | | |
| Basic | \$ 0.06 | \$ 0.05 |
| Diluted | \$ 0.05 | \$ 0.05 |

2. Recently Issued Accounting Standards

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123 (Revised 2004), *Share-Based Payment*, which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements based on alternative fair value models. The share-based compensation cost will be measured based on the fair value of the equity or liability instruments issued. The Company currently discloses pro forma compensation expense quarterly and annually. Upon adoption, the pro forma disclosures previously permitted under SFAS No. 123 will no longer be an alternative to financial statement recognition. The provisions of SFAS No. 123R are effective as of the beginning of the first interim or annual reporting period that begins after December 31, 2005. The Company is currently evaluating the method of adoption and the effect that the adoption of SFAS No. 123R will have on its financial position and results of operations.

3. Financing Agreements

In April 2003, the Company entered into a credit facility agreement with Wells Fargo Retail Finance, LLC. The facility expires on April 18, 2006 and provides financing for up to \$20.0 million, including a \$5.0 million sublimit for the issuance of letters of credit. Borrowings under the facility are based upon a percentage of eligible inventory less certain reserves. Borrowings are secured by inventory, equipment, general intangibles and other rights to payments. The credit facility prohibits the payment of cash dividends and contains various restrictive covenants

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including a limitation on the amount of capital expenditures and the number of stores the Company may open and close during any fiscal year.

Interest on borrowings is at prime plus up to .25% or Libor plus 1.75% to 2.25%, depending on the amount the Company has available for advances under the line of credit. The average interest rate on outstanding borrowings at April 2, 2005 was 4.5%. As of April 2, 2005 approximately \$11.0 million was available for advances under the facility.

Although the credit facility expires in April 2006 and the Company has the intent and ability to maintain this debt outstanding for more than one year, the Company has classified its borrowings under the facility as a current liability in accordance with the provisions set forth in Emerging Issues Task Force (EITF) 95-22 Balance Sheet Classifications, Borrowings Outstanding Under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.

Overview

General Shoe Pavilion, Inc., a Delaware corporation, operates as a single business segment of off-price shoe stores located in California, Washington, Oregon and Arizona under the name Shoe Pavilion. The Company operated 85 stores as of April 2, 2005 and April 3, 2004.

Results of Operations

Net sales. The Company's net sales for the thirteen weeks ended April 2, 2005 increased 19.0% to \$23.3 million from \$19.6 million for the same period in 2004. The increase was primarily due to the 10.7% increase in comparable store net sales and sales generated in six new stores opened during the period of June 2004 through March 2005, net of seven stores closed from June 2004 through March 2005.

Gross Profit. Cost of sales includes landed merchandise and occupancy costs. For the thirteen weeks ended April 2, 2005 gross profit increased 21.0% to \$8.0 million from \$6.6 million for the same period last year. Gross profit as a percentage of net sales increased to 34.4% for the thirteen weeks ended April 2, 2005 from 33.8% for the same period last year. As a percentage of net sales, the merchandising gross profit decreased 1.0% while occupancy costs decreased 1.6%. The decrease in merchandising gross profit as a percentage of net sales was in part due to the increase in the average cost per unit in women's footwear partially offset by a higher average selling price per unit. The decrease in occupancy costs as a percentage of net sales was due in part to the leveraging of occupancy costs as a result of the 10.7% increase in comparable store net sales during the quarter.

Selling, General and Administrative Expenses. For the thirteen weeks ended April 2, 2005 selling, general and administrative expenses increased by \$1.2 million or 21.2% to \$7.2 million from \$6.0 million for the same period last year. As a percentage of net sales, selling, general and administrative expenses were 31.0% for the thirteen weeks ended April 2, 2005 compared to 30.5% for the same period last year. The increase in selling, general and administrative expenses as a percentage of net sales is primarily due to the increase in advertising. Advertising as a percentage of net sales for the thirteen weeks ended April 2, 2005 was 5.4% compared to 4.0% for the same period last year. This increase in advertising is in part due to the timing of advertising for the Easter holiday season which was in the first quarter of 2005 while it was in the second quarter last year.

Interest Expense. Interest expense for the thirteen weeks ended April 2, 2005 increased to \$111,000 from \$72,000 compared to the same period last year. This increase in interest expense is primarily due to a higher average interest

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rate during the thirteen weeks ended April 2, 2005 compared to the same period last year and increased borrowings under the Company's credit facility, in part to fund the Company's increased inventory levels.

Liquidity and Capital Resources

Historically, the Company has funded its cash requirements primarily through cash flows from operations and borrowings under its credit facility. During the thirteen weeks ended April 2, 2005 and April 3, 2004, the Company satisfied its cash requirements through cash flows generated from operations. Net cash provided by operating activities was \$515,000 for the thirteen weeks ended April 2, 2005 compared to \$1.5 million for the same period last year. Cash provided from operating activities during the thirteen weeks ended April 2, 2005 and April 3, 2004 was primarily generated from an increase in accounts payable in part related to the increase in inventory.

Capital expenditures for the thirteen weeks ended April 2, 2005 were \$224,000. These expenditures primarily related to leasehold improvements and fixtures and equipment for one new store the Company opened during the thirteen weeks ended April 2, 2005 and construction in progress for three stores to be opened in the second quarter. The Company estimates that its total capital requirements to open a typical new store average \$574,000, consisting of approximately \$510,000 for inventory and \$64,000 for fixtures and equipment, excluding leasehold improvements which are frequently paid for by landlord allowances. Costs vary from store to store depending on, among other things, the location, size, property condition and tenant improvement package offered by the landlord. The Company expects to open between eight to ten stores during the remainder of 2005. The number of stores ultimately opened is, in part, dependent upon the availability of desirable locations and management's ability to negotiate acceptable lease terms.

During the thirteen weeks ended April 2, 2005 and April 3, 2004 financing activities used cash of \$195,000 and \$1.3 million which primarily relates to the pay down on the Company's credit facility.

In April 2003, the Company entered into a credit facility agreement with Wells Fargo Retail Finance, LLC. The facility expires on April 18, 2006 and provides financing for up to \$20.0 million, including a \$5.0 million sublimit for the issuance of letters of credit. Borrowings under the facility are based upon a percentage of eligible inventory less certain reserves. Borrowings are secured by inventory, equipment, general intangibles and other rights to payments. The credit facility prohibits the payment of cash dividends and contains various restrictive covenants including a limitation on the amount of capital expenditures and the number of stores the Company may open and close during any fiscal year.

Interest on borrowings is at prime plus up to .25% or Libor plus 1.75% to 2.25%, depending on the amount the Company has available for advances under the line of credit. The average interest rate on outstanding borrowings at April 2, 2005 was 4.5%. As of April 2, 2005 approximately \$11.0 million was available for advances under the facility.

Although the credit facility expires in April 2006 and the Company has the intent and ability to maintain this debt outstanding for more than one year, the Company has classified its borrowings under the facility as a current liability in accordance with the provisions set forth in Emerging Issues Task Force (EITF) 95-22 Balance Sheet Classifications, Borrowings Outstanding Under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement.

The Company expects that anticipated cash flows from operations and available borrowings under the Company's credit facility will satisfy its cash requirements for at least the next 12 months.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There have been no material changes from the information reported in the Company's Form 10-K for the year ended January 1, 2005.

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Item 4. Controls and Procedures

The Chief Executive Officer and the Chief Financial Officer of the Company have concluded, based on their evaluation as of the end of the period covered by this Report, that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports filed or submitted by it under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and include controls and procedures designed to ensure that information required to be disclosed by the Company in such reports is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in the Company's internal control over financial reporting that occurred during the quarter ended April 2, 2005 that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings

The Company is a party to various legal proceedings from normal business activities. Management believes that while it is reasonably possible that some of these matters will result in settlements to be paid by the Company, the ultimate resolution of these matters will not have a material adverse impact on the Company's financial statements.

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

None

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits required to be filed as part of this report:

31.1 Certification of CEO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of CEO and CFO pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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Item 6. Exhibits and Reports on Form 8-K (continued)

(b) Reports on Form 8-K filed during the quarter ended April 2, 2005:

(1) On January 10, 2005, the Company filed a Form 8-K reporting under item 2.02 the issuance of a press release announcing a 14.7% increase in comparable store sales for the fourth quarter 2004.

(2) On March 3, 2005, the Company filed a Form 8-K reporting under item 8.01 the issuance of a press release announcing that, as a result of a clarification issued by the Chief Accountant of the Securities and Exchange Commission released on February 7, 2005, the Company, like many other retailers, had reviewed its lease accounting practices and intended to change its lease accounting treatment and would restate its historical financial statements.

(3) On March 21, 2005, the Company filed a Form 8-K reporting under item 2.02 the issuance of a press release announcing certain financial information for the thirteen week fourth quarter and the 52 week period ended January 1, 2005. In addition, the Company reported under item 4.02 the issuance of a press release announcing that the Company's previously issued financial statements for the fiscal years ended January 3, 2004 (the 2003 Fiscal Year) and December 28, 2002 (the 2002 Fiscal Year) would be restated. As a result of the Company's determination to restate its financial statements, the financial statements included in the Company's Annual Reports on Form 10-K for the 2003 Fiscal Year and the 2002 Fiscal Year should no longer be relied upon. The Company included the restatement of these historical financial statements in its Annual Report on Form 10-K for the fiscal year ended January 1, 2005.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized on the 17th day of May 2005.

SHOE PAVILION, INC., as Registrant

By /s/ Dmitry Beinus
Dmitry Beinus

Chairman and Chief Executive Officer

By /s/ John D. Hellmann
John D. Hellmann

Vice President and Chief Financial Officer