LJ INTERNATIONAL INC
Form 20-F/A
May 24, 2007

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U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 20-F/A

o **REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR (g) OF THE SECURITIES EXCHANGE ACT OF 1934**

OR

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

For the fiscal year ended December 31, 2005

OR

o **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 0-29620

OR

o **SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Date of event requiring this shell company report__________

LJ INTERNATIONAL INC.
(Exact name of Registrant as specified in its charter)

LJ INTERNATIONAL INC.
(Translation of Registrant s name into English)

British Virgin Islands
(Jurisdiction of incorporation or organization)

Unit #12, 12/F, Block A
Focal Industrial Centre
21 Man Lok Street
Hung Hom, Kowloon, Hong Kong
(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of each class	Name of each exchange on which registered
None	N/A

Securities registered or to be registered pursuant to Section 12(g) of the Act.

$.01 Par Value Common Stock (Common Stock)
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None
(Title of Class)

Indicate the number of outstanding shares of each of the issuer s classes of capital or common stock as of the close of the period covered by the annual report:

15,521,203 Shares of Common Stock

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No þ

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes o No þ

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 þ No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark which financial statement item the registrant has elected to follow.

Item 17 o Item 18 þ

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

(APPLICABLE ONLY TO ISSUERS INVOLVED IN BANKRUPTCY PROCEEDINGS DURING THE PAST FIVE YEARS)

Indicate by check mark whether the registrant has filed all documents and reports required to be filed by Sections 12, 13 or 15(d) of the Securities Exchange Act of 1934 subsequent to the distribution of securities under a plan confirmed by a court.

Not Applicable.

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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This annual report contains forward-looking statements that involve risks and uncertainties. These include statements about our expectations, plans, objectives, assumptions or future events. In some cases, you can identify forward-looking statements by terminology such as anticipate, estimate, plans, potential, projects, continuing, ongoing, expects, management believes, we believe, we intend and similar expressions. These statements involv estimates, assumptions and uncertainties that could cause actual results to differ materially from those expressed for the reasons described in this annual report. You should not place undue reliance on these forward-looking statements.

You should be aware that our actual results could differ materially from those contained in the forward-looking statements due to a number of factors:

- dependence upon certain customers
- dependence on key personnel
- control by principal shareholder
- competitive factors
- the operation of our business
- general economic conditions

You should also consider carefully the statements under Risk Factors and other sections of this annual report, which address additional factors that could cause our actual results to differ from those set forth in the forward-looking statements and could materially and adversely affect our business, operating results and financial condition. All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the applicable cautionary statements.

The forward-looking statements speak only as of the date on which they are made, and, except to the extent required by federal securities laws, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events. In addition, we cannot assess the impact of each factor on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

We use data and industry forecasts in this annual report which we have obtained from internal surveys, market research, publicly available information and industry publications. Industry publications generally state that the information they provide has been obtained from sources believed to be reliable but that the accuracy and completeness of such information is not guaranteed. Similarly, we believe that the surveys and market research we or others have performed are reliable, but we have not independently verified this information.

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PART I

ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS

Not applicable.

ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE

Not applicable.

ITEM 3. KEY INFORMATION

A. SELECTED FINANCIAL DATA.

SELECTED CONSOLIDATED FINANCIAL DATA
(Dollars in thousands, except per share amounts)

The following selected consolidated financial data with respect to the two-year period ended April 30, 2002, eight months ended December 31, 2002 and the three-year period ended December 31, 2005 have been derived from our audited consolidated financial statements. The following selected consolidated financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and Notes included elsewhere in this annual report.

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Selected Financial Data

	Year ended December 31,				Eight-month period ended December 31,		Years ended April 30,	
	2005 (Restated)	**2004** (Restated)	**2003**	**2002** (Unaudited)	**2002**	**2001** (Unaudited)	**2002**	**2001**
Statement of Operations Data:								
Revenues	99,646	77,504	58,330	46,207	31,966	25,135	39,375	46,347
Cost of Goods sold	(77,127)	(61,265)	(44,947)	(39,951)	(22,820)	(18,602)	(35,731)	(31,540)
Gross profit	22,519	16,239	13,383	6,256	9,146	6,533	3,644	14,807
Operating expenses								
Selling, general and administrative	(15,488)	(11,578)	(9,133)	(9,525)	(6,433)	(5,905)	(8,963)	(9,398)
Net gain (loss) on derivatives	8	199	87	(975)	(435)	(119)	(660)	44
Depreciation	(1,368)	(1,032)	(1,184)	(1,328)	(863)	(565)	(1,031)	(808)
Impairment on property, plant and equipment			(84)	(417)	(108)		(345)	
Amortization and impairment loss on goodwill		(698)	(200)	(824)	(600)	(18)	(242)	(27)
Operating income (loss)	5,671	3,130	2,869	(6,813)	707	(74)	(7,597)	4,618
Other income and expenses Interest income	139	38	41	91	48	172	217	508
Interest expenses	(1,991)	(902)	(753)	(668)	(441)	(424)	(652)	(1,780)
Impairment loss on investment security				(200)	(200)			
Operating income (loss) before income taxes, minority interests, equity in results of investment securities and extraordinary item	3,819	2,266	2,157	(7,390)	314	(326)	(8,032)	3,346
Incomes taxes (expense) credit	(739)	(277)	(352)	39	(101)	(39)	101	(211)

Income (Loss) before minority interests, equity in results of investment securities and extraordinary item	3,080	1,989	1,805	(7,351)	213	(365)	(7,931)	3,135
Minority interests in consolidated subsidiaries	(20)		8	150	120		30	
Income before equity in results of investment securities and extraordinary item	3,060	1,989	1,813	(7,201)	333	(365)	(7,901)	3,135
Equity in results of investment securities			133	(851)	24	16	26	34
Income before extraordinary item	3,060	2,122	962	(7,177)	349	(339)	(7,867)	3,135
Extraordinary gain on negative goodwill	1,291							
Net income (loss)	4,351	2,122	962	(7,177)	349	(339)	(7,867)	3,135
Net income (loss) per share:								
Basic	0.32	0.19	0.11	(0.84)	0.04	(0.04)	(0.91)	0.37
Diluted	0.30	0.18	0.10	(0.84)	0.04	(0.04)	(0.90)	0.37
Weighted average number of shares								
Basic	13,439	11,119	8,757	8,551	8,493	8,672	8,672	8,567
Diluted	14,322	12,107	9,706	8,551	8,493	8,832	8,779	8,617
Balance Sheet Data:								
Working capital	35,554	23,617	17,053	11,896	11,896	18,537	12,115	20,153
Total assets	108,230	73,673	59,885	48,938	48,938	51,088	43,557	48,094
Long-term obligation	43	58	77			12	8	287
Total stockholders equity	45,008	32,790	27,101	23,344	23,344	30,969	23,591	31,161

Note 1: Pursuant to the purchase agreement dated January 1, 2005, the Company paid $2,827,500 for new issuance of 3,900 common stock of Goldleaves International Limited (GIL), in which the Company had 20% equity interests and was classified as investment security as of December 31, 2004. The Company then became the major stockholder holding 98% equity interests in GIL, which became a subsidiary of the Company. As of December 31, 2004, this investment was accounted for using the cost method. As appropriate for a step-acquisition, in the 2005 financial statements, the investment has been restated to account for under the equity method.

B. CAPITALIZATION AND INDEBTEDNESS.

Not applicable.

C. REASONS FOR THE OFFER AND USE OF PROCEEDS.

Not applicable.

D. RISK FACTORS.

We depend upon two customers who each account for at least 10% of our sales. We cannot be certain that these sales will continue; if they do not, our revenues will likely decline.

Although we sell to a large number of customers in a variety of markets, two of our customers each account for at least 10% of our sales. For the fiscal years ended December 31, 2005 and 2004, these customers accounted for approximately 13% and 11% of our 2005 sales and 11% and 9% of our 2004 sales. Although we have maintained good and longstanding relationships with these customers, we do not have any long-term contracts with them, each of whom orders only on a purchase order basis. The loss of any of these customers or a significant reduction in their orders would have a materially adverse effect on our revenues.

We are controlled by one of our existing shareholders, whose interests may differ from those of other shareholders.

Our largest shareholder beneficially owns or controls approximately 22.5% of our outstanding shares as of December 31, 2005. Accordingly, he has controlling influence in determining the outcome of any corporate transaction or other matters submitted to our shareholders for approval, including mergers, consolidations and the sale of all or substantially all of our assets, election of directors, and other significant corporate actions. He also has the

power to prevent or cause a change in control. In addition, without the consent of this shareholder, we could be prevented from entering into transactions that could be beneficial to us. The interests of this shareholder may differ from the interests of our other shareholders.

We face significant competition from larger competitors.

The making and distribution of jewelry is a highly competitive industry characterized by the diversity and sophistication of the product. We compete with major domestic and international companies with substantially greater financial, technical and marketing resources and personnel than us. There can be no assurance other jewelry makers will not similarly develop low-cost, high-volume production capability or an even better process, providing greater competition for us and materially affecting our business prospects.

There are numerous factors relating to the operations of our business that could adversely affect our success and results.

As a maker and merchandiser of low-cost, high-quality gem-set jewelry, our existing and future operations are and will be influenced by several factors, including:

- technological developments in the mass production of jewelry;
- our ability to meet the design and production requirements of our customers efficiently;
- the market acceptance of our and our customers jewelry;
- increases in expenses associated with continued sales growth;
- our ability to control costs;
- our management s ability to evaluate the public s taste and new orders to target satisfactory profit margins;
- our capacity to develop and manage the introduction of new designed products; and
- our ability to compete.

Quality control is also essential to our operations since customers demand compliance with design and product specifications and consistency of production. We cannot assure that revenue growth will occur on a quarterly or annual basis.

Our production facilities are located in China. Our results of operations and financial condition may, therefore, be influenced by the economic, political, legal and social conditions in China.

Since 1978, the Chinese government has been reforming, and is expected to continue to reform, China s economic and political systems. Such reforms have resulted in significant social progress. Other political, economic and social factors could also lead to further readjustment of the reform measures. This refinement and readjustment process may not always have a positive effect on our operations in China. At times, we may also be adversely affected by changes in policies of the Chinese government such as changes in laws and regulations or their

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interpretation, the introduction of additional measures to control inflation, changes in the rate or method of taxation and imposition of additional restrictions on currency conversion and remittances abroad.

Our products are currently made at our production facility located in Shenzhen, China. However, our insurance may not adequately cover any losses due to fire, casualty or theft.

We have obtained fire, casualty and theft insurance aggregating approximately $37 million, covering several of our stock in trade, goods and merchandise, furniture and equipment and production facility in China. The proceeds of such insurance may not be sufficient to cover material damage to, or the loss of, our production facility due to fire, severe weather, flood or other cause, and such damage or loss would have a material adverse effect on our financial condition, business and prospects. Consistent with the customary practice among enterprises in China and due to the cost in relation to the benefit, we do not carry any business interruption insurance in China.

Sales of our jewelry to retailers are generally stronger during the quarter ending December 31 of each year due to the importance of the holiday selling season.

The approximately 31% of our sales during the fiscal year ended December 31, 2005 to our TV shopping channel customers was not seasonal in nature. It has been our management s experience that the remaining 69% of our total sales is seasonally sensitive and is greater during the quarter ending December 31 of each year.

Our holding company structure creates restrictions on the payment of dividends.

We have no direct business operations, other than the ownership of our subsidiaries. While we have no current intention of paying dividends, should we, as a holding company, decide in the future to do so, our ability to pay dividends and meet other obligations depends upon the receipt of dividends or other payments from our operating subsidiaries and other holdings and investments. In addition, our operating subsidiaries are subject to restrictions on their ability to make distributions to us, including as a result of restrictive covenants and minimum net worth requirements in loan agreements, restrictions on the conversion of local currency into U.S. dollars or other hard currency and other regulatory restrictions.

It may be difficult to serve us with legal process or enforce judgments against us or our management.

We are a British Virgin Islands holding company, and substantially all of our assets are located in China and Hong Kong. In addition, all but one of our directors and officers are non-residents of the United States, and all or substantial portions of the assets of such non-residents are located outside the United States. As a result, it may not be possible to effect service of process within the United States upon such persons. Moreover, there is doubt as to whether the courts of the British Virgin Islands, China or Hong Kong would enforce:

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judgments of United States courts against us, our directors or our officers based on the civil liability provisions of the securities laws of the United States or any state; or

in original actions brought in the British Virgin Islands, China or Hong Kong, liabilities against us or non-residents based upon the securities laws of the United States or any state.

Some information about us may be unavailable due to exemptions under the Exchange Act for a foreign private issuer.

We are a foreign private issuer within the meaning of the rules under the Exchange Act. As such, we are exempt from certain provisions applicable to United States public companies, including:

the rules under the Exchange Act requiring the filing with the Securities and Exchange Commission of quarterly reports on Form 10-Q or current reports on Form 8-K;

the provisions of Regulation FD aimed at preventing issuers from making selective disclosures of material information;

the sections of the Exchange Act regulating the solicitation of proxies, consents or authorizations applicable to a security registered under the Exchange Act; and

the sections of the Exchange Act requiring insiders to file public reports of their stock ownership and trading activities and establishing insider liability for profits realized from any short-swing trading transaction.

Because of these exemptions, investors are not provided with the same information which is generally available about public companies organized in the United States.

Since we are a British Virgin Islands company, the rights of our shareholders may be more limited than those of shareholders of a company organized in the United States.

Under the laws of most jurisdictions in the United States, majority and controlling shareholders generally have certain fiduciary responsibilities to the minority shareholders. Shareholder action must be taken in good faith, and actions by controlling shareholders which are obviously unreasonable may be declared null and void. British Virgin Islands law protecting the interests of minority shareholders may not be as protective in all circumstances as the law protecting minority shareholders in U.S. jurisdictions. In addition, the circumstances in which a shareholder of a BVI company may sue the company derivatively, and the procedures and defenses that may be available to the company, may result in the rights of shareholders of a BVI company being more limited than those of shareholders of a company organized in the U.S.

Furthermore, our directors have the power to take certain actions without shareholder approval which would require shareholder approval under the laws of most U.S. jurisdictions. The directors of a BVI corporation, subject in certain cases to court approval but without shareholder approval, may implement a reorganization, merger or consolidation, the sale of any assets, property, part of the business, or securities of the corporation. Our ability to amend our Memorandum of Association and Articles of Association without shareholder approval could have the effect of delaying, deterring or preventing a change in our control without any further action by the shareholders, including a tender offer to purchase our common stock at a premium over then current market prices.

ITEM 4. INFORMATION ON THE COMPANY

A. HISTORY AND DEVELOPMENT OF THE COMPANY.

LJ International Inc. (we) was incorporated as an international business company under the International Business Companies Act of the British Virgin Islands on January 30, 1997. As of December 31, 2005, we owned all of the issued share capital in the following significant subsidiaries:

Lorenzo Jewelry Limited (Lorenzo Jewelry), a company incorporated in Hong Kong on February 20, 1987

Lorenzo Jewellery (Shenzhen) Co., Ltd.

Shenzhen PGS Jewelry Mfg.

Lorenzo (Shenzhen) Co., Ltd.

Lorenzo Crystal Ltd.

Enzo (Shenzhen) Co., Ltd.

Enzo Ltd.

Goldleaves Gems (Shenzhen) Co., Ltd. (98% equity ownership)

Due to the restrictions on foreign ownership on the retail business of jewelries, the Company, through loans to the agents, established LSC and ESC to carry out the retail business of jewelries in the PRC. Pursuant to various agreements entered into between the Company, the agents and LSC on May 21, 2004, the agents and ESC on July 14, 2005, the Company generally has control of LSC and ESC, absorbs majority of expected losses and receives majority of residual return of LSC and ESC. The Company is therefore considered the primary beneficiary of LSC and ESC. Accordingly, the results of LSC and ESC are consolidated in the financial statements of the Company since May 21, 2004 and July 14, 2005 respectively.

Our principal place of business and our executive offices are located at Units #09-#12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong, telephone: (011) 852-2764-3622. We have designated CT Corporation, 111 Eighth Avenue, New York, New York 10011 as our agent for service of process in the United States.

During our last three fiscal years, we have made the following significant capital expenditures:

we invested $390,000 for the purchase of 1,751 square meters of production space in our Shenzhen, China facility during the fiscal year ended December 31, 2003

we invested $670,000 for the purchase of 1,639 square meters of production space in our Shenzhen, China facility during the fiscal year ended December 31, 2005

we acquired additional 78% of the equity of Goldleaves International Limited for $2,827,500 during the fiscal year ended December 31, 2005

B. BUSINESS OVERVIEW.

We are a totally vertically integrated company that designs, brands, markets and distributes a complete range of fine jewelry. While we specialize in the semi-precious jewelry

segment, we also offer high-end pieces set in yellow gold, white gold, platinum or sterling silver and adorned with semi-precious stones, diamonds, pearls and precious stones. We distribute mainly to fine jewelers, department stores, national jewelry chains and electronic and specialty retailers throughout North America and Western Europe. Our product lines incorporate all major categories sought by major retailers, including earrings, necklaces, pendants, rings and bracelets.

We believe that our vertically integrated structure provides significant advantages over our competitors. All profits from value added processes are captured internally, rather than shared with third party manufacturers. This results in very competitive pricing for the retailer and enhanced profits for us. Innovative processes in stone cutting and production further enhance our competitive position.

We employ an international design team and all of our designs and merchandising strategies are proprietary. The exclusive and innovative concepts that we create offer brand potential. Our primary marketing focus has been in North America where we have sold directly to certain high volume customers that need specialized product development services, and through a marketing relationship with International Jewelry Connection (IJC) for those customers that need higher levels of service and training.

We organize our marketing and distribution strategies by retail distribution channels. Concepts are developed for the specific needs of different market segments. We have identified the following as prime retail targets:

- fine jewelers;
- national jewelry chains;
- department stores;
- TV shopping channels; and
- discount chain stores.

For the years ended December 31, 2004 and 2005, approximately 72% and 68% of our sales were in North America.

In addition to our supply chain line of business involving direct sales to retailers, we have expanded into the retail sales line of business involving direct sales to consumers in China through company-owned retail stores under the brand name ENZO. In March 2004, we opened our first ENZO store in Hong Kong and we opened our flagship store in Shanghai in November 2004. We currently operate 18 ENZO retail stores in Hong Kong and China, and we expect to open an additional 20 retail stores in 2006.

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The following is a breakdown of our total revenues (in thousands) by geographic market for each of our past three financial years:

	Year ended December 31,		
	2005	2004	2003
US & Canada	67,780	56,186	42,851
Europe and other countries	20,527	13,062	8,017
Japan	3,686	4,158	5,338
PRC (including Hong Kong and Macau)	7,653	4,098	2,124
	99,646	77,504	58,330

Our Industry

The U.S. jewelry industry is a highly fragmented $45 billion market, with no single entity having more than 6% market share. The industry consists primarily of three retail sectors:

specialty retailers account for $27 billion in sales

mass merchants and department stores account for $12 billion in sales

direct avenues (television shopping, e-commerce, catalogs) account for $6 billion

The U.S. jewelry industry is comprised of two major groups that distribute finished jewelry to retailers in the United States:

a small number of producers that make and distribute their own jewelry directly to retailers; and

a large number of wholesalers and distributors who purchase products or portions of products from third parties and resell those items to retailers.

We believe that vertically integrated companies that control costs by performing all value added processes enjoy a distinct competitive advantage over wholesalers and distributors who pay premium acquisition prices for items that they intend to resell. We further believe that large retailers want to rely upon prime producers because they believe that prime producers are reliable and low cost producers who can accommodate the large quantities of production that large retailers commonly purchase.

The Chinese jewelry industry has experienced rapid development due to a series of major reforms, including the liberalization of China s gold market, the lowering of tariff rates, and the decision of the Chinese Government to open up the retail sector to international companies.

In addition, rising income levels coupled with the growing urban population in China has helped the jewelry market record double-digit growth annually. The continuing acceleration of the urbanization trend in China will likely result in improved income levels, thereby increasing private consumption. The Chinese Government has also encouraged consumer spending by instituting longer national holidays and increasing the salary of civil servants.

China is the largest consumer of platinum and jade in the world for the past three years, the largest consumer of diamonds in Asia, and the fourth largest consumer of gold in the world.

Our Business Strategy

Our business strategy is to:

- increase our market share of moderately priced high-quality gem-set semi-precious and precious jewelry by capitalizing on our unique vertically integrated production processes to produce diamond and high-end precious stone jewelry in addition to high volume, high-quality semi-precious products;

- further develop our existing customer relationships with our specialized services; and

- expand aggressively into new distribution channels, particularly in the United States and throughout Western Europe, Japan, China, and Australia.

We are aggressively developing new product lines in exotic stones, which have high perceived values among semi-precious stones. We continue to expand into new product categories by:

- marketing a line of sterling silver jewelry. These are typically merchandised with a retail price range of $30 to $150

- adding more lines into our Lorenzo branded products with a retail price range of $199 to $999

- offering diamond jewelry and expanding this business to our current client base by adding diamonds to some of our settings, as well as offering newly designed jewelry

- launching Lorenzo Gold , our new gold jewelry product line

Our China Retail Sales Strategy

In 2004, we initiated a retail sales strategy aimed at gaining market share in the rapidly growing consumer market in China. We opened three ENZO stores, two in China (including a flagship store in Shanghai) and one in Hong Kong. We believe that China represents an excellent retail sales opportunity for several reasons:

- enormous retail market China s retail sales exceed $600 billion annually, making China the third largest market in the world.

- large and growing jewelry market we estimate that China s jewelry sales totaled nearly $15 billion in 2002, up 19% year over year.

- huge pool of consumers China has a population of 1.3 billion persons. We estimate that roughly 160 million Chinese have enough income to purchase luxury goods.

- favorable regulatory changes as a member of the World Trade Organization (WTO), China is eliminating many restrictions on foreign ownership and operation of retail stores. Tariffs on colored gem stones, gold, silver and pearls have been sharply reduced, and economic and trade relationships between China and Hong Kong have been liberalized.

- changing consumer preferences   Chinese consumers are no longer purchasing jewelry solely as an investment. More Chinese consumers are embracing a more Western view of jewelry as a fashion accessory and now demand more contemporary, colorful designs.

We are expanding into China by means of Company-owned and operated retail stores and supplier relationships with leading retailers, such as Carrefour.

We intend to implement our business strategy by:

- expanding our retail jewelry market in China by planning to open an additional 20 ENZO stores in China during 2006

- promoting visits with customers to coordinate and cater to their particular promotional sales needs and monitoring their on-hand inventory in order to promote more active sell-through

- expanding our distribution channels to include all major TV shopping programs in North America, Japan, Korea and Australia and further developing business with top-40 Retail Jewelry Chains in the U.S.

Our Production Capability

We have established a sophisticated facility in China that performs stone cutting and polishing and jewelry production. The facility is located in the city of Shenzhen in Guangdong Province, China. Our production facility in Shenzhen has been operating for seven years and has more than 10,000 square meters of production space. We currently employ approximately 2,800 skilled gemstone cutters and production personnel and turned out approximately two million pieces of finished fine jewelry during the fiscal year ended December 31, 2005.

We purchase imported choice gemstone material, which are from mines located in Africa, China and South America, especially those concentrated in Brazil. We source our diamonds mainly from suppliers in India. Gemstone craftsmen are trained and managed by our Hong Kong personnel to ensure that the highest levels of cutting and polishing quality are achieved. The professional skills possessed by our cutters are applied to a wide variety of shapes and sizes, maximizing the yield and value of the gemstone material that we purchase. By performing internally the value-added processes of cutting and polishing our semi-precious gemstones, we maximize quality control and improve our profitability. We specialize in a wide range of popular and exotic semi-precious gemstones ranging from amethyst, aquamarine and peridot to tanzanite and tourmaline.

Sales and Marketing

Our merchandising strategy is to provide unique and differentiated products that are enhanced by the favorable pricing that results from our vertically integrated structure. We invest significant effort in design and model making to produce items which are distinctly different from those of our competitors. We continue to devote our efforts towards brand development and utilize marketing concepts to enhance the saleability of our products. We recognize that retailers favor certain price points. As part of our product development strategy, we strive to

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align our wholesale prices to match retailers target prices as a means of achieving these popular price targets.

Our sales and marketing team is located in our executive offices in Hong Kong and Los Angeles, California. Our marketing and distribution strategy is to identify the strongest retail customers in each distribution channel and to focus design and sales efforts towards the largest and fastest growing retailers. We maintain a broad base of customers and concentrate our efforts on five major jewelry market segments:

- fine jewelers;
- national jewelry chains;
- department stores;
- TV shopping channels; and
- discount chain stores.

In addition to direct sales to retailers, we also sell our products to retailers through International Jewelry Connection. The principal focus of IJC is on major U.S. department stores and jewelry retailers, who require specialized levels of marketing, service and training. These sales representatives are paid on a commission-only basis.

Our sales promotion efforts include attendance by our representatives at U.S. and international trade shows and conventions, including Las Vegas, Orlando, New York, Basel, Switzerland, Hong Kong and Japan. In addition, we advertise actively in trade journals and related industry publications.

Design and Product Development

We have 20 internationally trained designers who work from our Hong Kong, U.S. and China offices. Our designers create styles that have been accepted by our various clients worldwide. Our design teams attend trade fairs worldwide to gather product ideas and monitor the latest product trends.

We provide our customers with a broad selection of high-quality 10, 14 and 18 karat gold, platinum and sterling silver jewelry products that incorporate traditional yet fashionable styles and designs. We currently offer more than 50,000 different styles of rings, bracelets, necklaces, earrings, pendants and matching sets that are contemporary and desired in the market.

We study product trends that are emerging in the international market and adapt these trends to the needs of our retail customers. The jewelry offered for sale considers color, fabric and fashion trends, which are projected over a two-year period. We market our products as lifestyle inspired.

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Production Process

We make our jewelry at our facility in Shenzhen, China. Our production processes combine vertical integration, modern technology, mechanization and handcraftsmanship to turn out contemporary and fashionable jewelry. Our production operations basically involve:

- cutting and polishing semi-precious gemstones;
- combining pure gold, platinum or sterling silver with gemstones or diamonds to produce jewelry; and
- finishing operations such as cleaning and polishing, resulting in high quality finished jewelry.

Supply

We cut our own semi-precious stones. We purchase imported gemstones which are from South America, Africa and China. South America is the major source of ametrine, amethyst, aquamarine, imperial topaz, tourmaline and white topaz, and Africa is the main source of tanzanite, mandarine garnet, aquamarine and topaz. We also purchase imported aquamarine, peridot and topaz from China. We source our diamonds mainly from suppliers in India. We believe that we have good relationships with our suppliers, most of whom have supplied us for many years.

We maintain our supply of inventory at our warehouse. The amount of our inventory of a particular gemstone determines the extent and size of our marketing program for that product. We purchase our gemstones and diamonds in advance and in anticipation of orders resulting from our marketing programs.

We purchase our gold from banks, gold refiners and commodity dealers who supply substantially all of our gold needs, which we believe is sufficient to meet our requirements.

Gold acquired for production is at least .995 fine and is combined with other metals to produce 10, 14 and 18 karat gold. The term karat refers to the gold content of alloyed gold, measured from a maximum of 24 karats, which is 100% fine gold. Varying quantities of metals such as silver, copper, nickel and zinc are combined with fine gold to produce 14 karat gold of different colors. These alloys are in abundant supply and are readily available to us.

We purchase our gold requirements within a reasonable period after each significant purchase order is received. We believe that any change in the price of gold would have had little, if any, impact on the valuation of our inventories.

We purchase supplies and raw materials from a variety of suppliers and we do not believe the loss of any of the suppliers would have a material adverse effect on our business. Alternative sources of supply for raw materials for production of jewelry are readily available.

Security

We have installed certain measures at our Shenzhen, China, production and our Hong Kong administrative facilities to protect against loss, including multiple alarm systems, infrared

motion detectors and a system of closed circuit television cameras, which provide surveillance of all critical areas of our premises.

We carefully inspect all materials sent and received from outside suppliers, monitor the location and status of all inventory, and have strict internal control procedures of all jewelry as it proceeds through the production process. A complete physical inventory of gold and gemstones is taken at our production and administrative facilities on a quarterly basis.

Insurance

We maintain primary all-risk insurance, with limits in excess of our current inventory levels, to cover thefts and damage to inventory located on our premises. We also maintain insurance covering thefts and damage to our owned inventory located off-site. The amount of coverage available under such policies is limited and may vary by location, but is generally in excess of the value of the gold and gemstones supplied by us. We carry transit insurance, the coverage of which includes the transportation of jewelry outside of our office.

Competition

The jewelry production industry is highly competitive, and our competitors include domestic and foreign jewelry manufacturers, wholesalers, and importers who may operate on a national, regional and local scale. Our competitive strategy is to provide competitively priced, high-quality products to the high-volume retail jewelry market. According to our management, competition is based on pricing, quality, service and established customer relationships. We believe that we have positioned ourselves as a low-cost producer without compromising our quality. Our ability to conceive, design and develop products consistent with the requirements of each retail distribution channel represents a competitive advantage.

We believe that few competitors have the capacity and production skills to be effective competitors. We believe that our vertically integrated production capabilities distinguish us from most of our competitors and enable us to produce very competitively priced, high quality and consistent products.

The North American market is highly fragmented but does contain a number of major competitors, many of whom import much of their product from the Far East and many of whom sell higher priced items. The key United States competitors include E.E.A.C. Inc. and Fabrikant. International competitors include Pranda International and Beauty Gems Limited. Most of these manufacturers/wholesalers have been successful vendors for many years and enjoy good relations with their clients. Although it may be difficult for a newcomer to break into established relationships, we have already made substantial inroads in the North American jewelry market and we believe we can remain competitive, based on our vertically integrated, low-cost, high-volume and high-quality production process.

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C. ORGANIZATIONAL STRUCTURE AS OF DECEMBER 31, 2005:

The following diagram provides a listing of our significant subsidiaries. The respective country of organization/incorporation is shown in brackets.

LJ INTERNATIONAL INC.
(British Virgin Islands)

100%

- **Lorenzo Jewelry Limited** (Hong Kong)
- **Lorenzo Jewellery (Shenzhen) Co., Ltd.** (P.R.C.)
- **Shenzhen PGS Jewelry Mfg.** (P.R.C.)
- **Goldleaves Gems (Shenzhen) Co., Ltd.** (P.R.C.) (98% equity ownership)
- **Lorenzo (Shenzhen) Co., Ltd.** (P.R.C.)
- **Lorenzo Crystal Ltd.** (Hong Kong)
- **Enzo (Shenzhen) Co., Ltd.** (P.R.C.)
- **Enzo Ltd.** (Macau)

D. PROPERTY, PLANTS AND EQUIPMENT.

Our principal executive offices are located at Units #9-#12, 12/F, Block A, Focal Industrial Centre, 21 Man Lok Street, Hung Hom, Kowloon, Hong Kong. We own approximately 4,800 square feet of office and showroom at this location.

Our jewelry production facility in Shenzhen, China consists of 12,918 square meters of building space located in the Shatoujiao Free Trade Zone, Shenzhen. We own approximately 6,893 square meters of this space. We also currently lease:

1,751 square meters for a term of five years expiring August 31, 2007 from an unaffiliated third party at a rental rate of $3,817 per month;

1,751 square meters for a term of two years expiring June 30, 2006, at a rental rate of $3,567 per month;

475 square meters for a term of one year expired December 31, 2005, at a rental rate of $854 per month, extension of lease is under negotiation;

600 square meters for a term of three years expired October 31, 2005, at a rental rate of $1,333 per month, extension of lease is under negotiation; and

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1,886 square meters for a term of three years and eleven months expiring September 30, 2006, at a rental rate of $4,425 per month.

We own two warehouse facilities in Hung Hom and Aberdeen consisting of 5,432 square feet and 5,200 square feet. We also own additional properties in Sai Kung and Hung Hom. We lease all four of these properties to non-affiliated third parties. We have pledged all of our land and buildings to collateralize general banking facilities granted to us.

Our production facilities are currently utilized for one shift per day but are capable of being expanded to accommodate three shifts per day as necessary.

ITEM 4A. UNRESOLVED STAFF COMMENTS

Not applicable.

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ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS

The following discussion and analysis should be read in conjunction with our financial statements and notes to the financial statements appearing elsewhere in this Form 20-F. See Special Note Regarding Forward-looking Statements.

We design, manufacture, distribute and market full range of fine jewelry for sale in the worldwide jewelry market.

Our products include rings, bracelets, necklaces, earrings and pendants, and we are one of the strongest players in color gemstones that employs the mine-to-market strategy. Most of the color gemstones are imported from Brazil which supplies the best color gemstones in the world, the choices of which to customers are many and diversified that includes, amongst others, ametrine, amethyst, aquamarine, imperial topaz, tourmaline, white topaz, tanzanite, mandarine garnet, topaz, ruby, sapphire and emerald. Our customers include fine jewelers, national jewelry chain stores, department stores and television shopping networks in North America, Western Europe, Japan and China. The business strategies of the Company include broadening the product line, and diversifying its customer base.

We are based in Hong Kong and our business model comprises two streams: Supply Chain and Retail Chain. The revenue mix of the two businesses was roughly in the ratio of 97% to 3% for the year ended December 31, 2005.

The Supply Chain focuses on the US market with sales made to those $100 Million Supersellers such as Sterling Jewelers Inc., Fred Meyer Jewelers, Helzberg Diamonds, ShopNBC, Zales Corporation, QVC, Wal-Mart, Finlay Fine Jewelry, Home Shopping Network, Ben Bridge Jeweler, Kohl s Corporation, Macy s East, Macy s West and J.C. Penney. The turnover of our sales to those Supersellers in the US and Canada amounted to $67.8 million for 2005 compared to $56.2 million in 2004, an increase of 20.6%.

Employing the brand new ENZO name, the Retail Chain focuses primarily on the China market. Shortly after the year end date, on January 20, 2006, ENZO in China reached the 20-store milestone, which was well-ahead of our schedule of achieving at least 40 retails stores by the end of 2006. ENZO now has one or more retail locations in China s richest and largest population cities, including Shanghai, Beijing, Harbin, Qingdao, Shenyang, Ningbo, Chengdu, Changsha, Wuxi and Shenzhen. The best selling jewelries are in the price range of $300 to $500, and the population groups with annual income of $800 to $1,200 are most eager to buy fine jewelries. Jewelries made of 18K gold are most popular, followed by 24K s. Most popular diamonds are of 0.21 carats to 0.49 carats.

ENZO is opening another two retail locations in the coming months, one at the SkyPlaza of the Hong Kong International Airport and one at Parklane of Tsim Sha Tsui. In the middle of 2006, ENZO is opening a 10,000 square feet mega store in Macau which is located in the Palace of the Fisherman s Wharf. The opening of the Macau mega store will be truly be a significant

milestone in the execution of the retail strategy in Greater China as well as in Asia. Macau is a prime destination not only for gambling but for other recreation as well both for dining and other family activities. The Fisherman s Wharf is expected to draw at least 15 million people in just its first year of opening and will steadily grow from there. Our mega store, located in the central of the Wharf, offers a full range of products to millions of affluent customers throughout the year, and we are pleased to be able to execute a faster track record of new store openings than all other competitors put together.

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A. OPERATING RESULTS.

Reclassifications

Certain prior year amounts have been reclassified to conform to the current year presentation.

Revenues

	Year ended December 31			% change Years ended December 31,	
(in thousands)	2005	2004	2003	2005-2004	2004-2003
Revenue					
Wholesales					
Jewelry product	$ 95,318	$ 72,337	$ 55,542	32%	30%
Giftware product	$ 1,827	$ 4,359	$ 2,788	-58%	56%
	$ 97,145	$ 76,696	$ 58,330	20%	32%
Retail business	$ 2,501	$ 808	$	210%	N/A
	$ 99,646	$ 77,504	$ 58,330	29%	33%

The increase in revenue of jewelry product of wholesales of $22,981,000 or 32% to $95,318,000 for the year ended December 31, 2005, compared to the year ended December 31, 2004, was attributable to an increase in average selling price of 2% amounting to $1.4 million, and increase in order quantity of 34% amounting to $21.6 million.

The decrease in revenue of giftware product of wholesales of $2,532,000 for the year ended December 31, 2005, compared to the year ended December 31, 2004, was due to the closure of this product line with low profit margin during the third quarter of 2005.

The increase in revenue of retail business by $1,693,000 or 210 % for the year ended December 31, 2005 from the revenue of $808,000 for the year ended December 31, 2004. The retail business was newly launched in 2004 which involved direct sales to consumers in Hong Kong and China through company-owned retail stores under the brand name ENZO. Due to the expansion, the number of retail stores was increased to 18 ENZO retail stores in Hong Kong and China at December 31, 2005, compared to 3 stores at December 31, 2004.

The increase in revenue of jewelry product of wholesales of $16,795,000 or 30% to $72,337,000 for the year ended December 31, 2004, compared to the year ended December 31, 2003, was attributable to an increase in average selling price of 10% amounting to $5.6 million, and increase in order quantity of 13% amounting to $11.2 million.
The increase in revenue of giftware products of $1,571,000 or 56% for the year ended December 31, 2004 from the revenue of $2,788,000 for the year ended December 31, 2003 was due to the increase in customers and increase of giftware products for sales. The giftware products were introduced in 2003.

Cost of Sales and Gross Profit

	Year ended December 31,			% Change	
(in thousands)	2005	2004	2003	Years ended December 31, 2005-2004	Years ended December 31, 2004-2003
Cost of sales and gross profit					
Cost of sales					
Wholesales	$ 75,645	$ 60,564	$ 44,947	25%	35%
% of revenues	78%	79%	77%		
Retail	$ 1,482	$ 701	$ 0	111%	N/A
% of revenues	59%	87%	0%		
Total	$ 77,127	$ 61,265	$ 44,947	26%	36%
% of revenues	77%	79%	77%		
Gross profit					
Wholesales	$ 21,500	$ 16,132	$ 13,383	33%	21%
% of revenues	22%	21%	23%		
Retail	$ 1,019	$ 107	$ 0	852%	N/A
% of revenues	41%	13%	0%		
Total	$ 22,519	$ 16,239	$ 13,383	39%	21%
% of revenues	23%	21%	23%		

The gross profit margin increased to 23% for the year ended December 31, 2005 from 21% for the year ended December 31, 2004 was attributable to the closure of the low profit margin of giftware products lines in wholesales business; and to the newly incepted retail business with higher gross margin for the year ended December 31, 2005.

The gross profit margin dropped to 21% for the year ended December 31, 2004 from 23% for the year ended December 31, 2003. The decrease in gross margin of wholesales business was due to rise in diamond price which we could not pass to the customer for orders accepted before the rise in price and also to sales to discount chain stores. The gross profit margin of retail business for the year ended December 31, 2004 was low at the beginning of a new business.

Selling, General and Administrative Expenses

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2005	2004	2003	2005-2004	2004-2003
Selling, general and administrative expenses					
Wholesales business	$ 12,356	$ 10,944	$ 9,133	13%	20%
Acquired manufacturing subsidiaries	$ 479	$ 0	$ 0	N/A	N/A
Retail business	$ 2,653	$ 634	$ 0	318%	N/A
	$ 15,488	$ 11,578	$ 9,133	34%	27%
% of revenues	16%	15%	16%		

Selling, general and administrative expenses increased by 34% for the year ended December 31, 2005, compared with the year ended December 31, 2004. It was attributed to the increase in development cost of new products, designs and markets by 21% for wholesale business, and expenses incurred by the retail business of $2,653,000 comprising advertising cost of $816,000, rental cost of $275,000, staff cost of $727,000 and other expenses of $835,000, or 318% increase of the same for the year ended December 31, 2004.

Selling, general and administrative expenses increased by 27% for the year ended December 31, 2004, compared with the year ended December 31, 2003. It was attributed to the development cost of new products, designs and markets of $1,200,000 for wholesales business, and expenses incurred by the newly incepted retail business of $634,000 comprising advertising cost of $135,000, rental cost of $85,000, staff cost of $306,000 and other expenses of $108,000, for the year ended December 31, 2004.

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Net gain (loss) on derivatives

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2005	2004	2003	2005-2004	2004-2003
Unrealised loss on derivatives	$ (88)	$ (482)	$ (162)	-82%	198%
% of revenues	0%	-1%	0%		
(With the hedging mechanism in place, we have the realised gain on hedging activities)					
Realized gain on hedging activities	$ 96	$ 681	$ 249	-86%	173%
% of revenues	0%	1%	0%		
Net gain on derivatives and hedging activities	$ 8	$ 199	$ 87	-96%	129%
% of revenues	0%	0%	0%		

We have secured gold loan facilities with various banks in Hong Kong, which typically bear a below-market interest rate. Under the gold loan arrangements, we may defer the purchase until such time as we decide appropriate, the price to be paid being the current market price at time of payment. The gold loan, however, does expose us to certain market risks associated with potential future increases in the price of gold. In the past, we did not hedge against such risks and at the close of each reporting period, the gold loan was valued at fair value with changes reflected on the income statement.

Since 2003, we have commenced hedging the fluctuations in the price of gold related to the gold loans by entering into contracts with financial institutions for the future purchase of gold. With the hedging mechanism in place, we have incurred an unrealized loss of $88,000 (2004: $482,000) and realized gain of $96,000 (2004: $681,000) on derivatives, for the year ended December 31, 2005.

Persistently, after the hedging mechanism in place since 2003, we secured position of a net gain on derivative hedging activities of $87,000, $199,000 and $8,000 for each of the years ended December 31, 2003, December 31, 2004 and December 31, 2005 respectively.

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Depreciation

(in thousands)	Year ended December 31, 2005	2004	2003	% Change Years ended December 31, 2005-2004	Years ended December 31, 2004-2003
Depreciation					
Wholesales	$ 1,154	$ 991	$ 1,184	16%	-16%
% of revenues	1%	1%	2%		
Retail	$ 214	$ 41	$ 0	422%	N/A
% of revenues	9%	5%	0%		
Total	$ 1,368	$ 1,032	$ 1,184	33%	-13%
% of revenues	1%	1%	2%		

Depreciation increased by 33% to $1,368,000 for the year ended December 31, 2005 from $1,032,000 for the year ended December 31, 2004, reflecting the amortization on the on-going capital expenditures, capitalized computer system of wholesales business and renovation of retail shops during the year.

Depreciation decreased by 13% to $1,032,000 for the year ended December 31, 2004 from $1,184,000 for the year ended December 31, 2003. It was resulted from a portion of fully depreciated furniture, fixtures and equipment during the year.

Amortization and impairment loss on goodwill

(in thousands)	Year ended December 31, 2005	2004	2003	% Change Years ended December 31, 2005-2004	Years ended December 31, 2004-2003
Amortization and impairment loss on goodwill	$ 0	$ 698	$ 200	-100%	249%
% of revenues	0%	1%	0%		

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In April 2001, we acquired 20% equity interests in a company whose principal activities are the manufacturing and trading of rough and pre-formed gemstones, of which we had no significant control and influence over its operating and financial policies, the investment is stated at cost previously. On January 1, 2005, additional equity interest was acquired in this company, which become a subsidiary of the Company. As appropriate for a step-acquisition, the interest as of December 31, 2004 was restated to account for under equity method. As a result, impairment loss of $698,000 arising from investment securities was charged for the year ended December 31, 2004.

In March 2002, goodwill was arisen as a result of the acquisition of a fine jewelry company. Impairment loss of $200,000 of the related goodwill was charged for the year ended December 31, 2003.

Interest cost

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2005	2004	2003	2005-2004	2004-2003
Interest expenses	$ 1,991	$ 902	$ 753	121%	20%
% of revenues	2%	1%	1%		

Interest expenses increased for the years ended December 31, 2003, 2004 and 2005 reflecting the continuous increase in interest rate and a higher utilization rate of credit line facilities as working capital.

Income taxes

				% Change	
	Year ended December 31,			Years ended December 31,	Years ended December 31,
(in thousands)	2005	2004	2003	2005-2004	2004-2003
Incomes taxes expense	$ 739	$ 277	$ 352	167%	-21%
% of revenues	1%	0%	1%		

We were incorporated in the British Virgin Islands and, under current law of the British Virgin Islands, are not subject to tax on income or on capital gains.

For our subsidiaries in Hong Kong, the prevailing corporate income tax rate is 17.5%.

Three of our subsidiaries in China are registered to be qualified as Foreign Investment Enterprises in China and are eligible for certain tax holidays and concessions. Accordingly, certain of our Chinese subsidiaries are exempt from Chinese income tax for two years starting from their first profit-making year, followed by a 50% reduction of tax for the next three years.

One of our subsidiaries in China has its tax exemption and concessions expired at the end of 2004. Another subsidiary in China is enjoying the tax holiday as its first profit-making year in 2004 and another subsidiary in China is enjoying the tax holiday as its first profit-making year in 2005. PRC income tax is calculated at the applicable rates relevant to these subsidiaries which currently are 15%.

For other subsidiaries in China, the prevailing corporate income tax rate is 33%. The prevailing corporate income rate is 15% for companies operating in special economic zones of China.

During the year ended December 31, 2005, incomes taxes included tax under provision adjustment of $88,000, and for the years ended December 31, 2004 and 2003, incomes taxes included tax overprovision adjustment of $22,000 and $92,000 respectively, after the finalization of tax assessment for prior years.

Extraordinary gain on negative goodwill

				% Change	
	Year ended December 31,			**Years ended December 31,**	**Years ended December 31,**
(in thousands)	**2005**	**2004**	**2003**	**2005-2004**	**2004-2003**
Extraordinary gain on negative goodwill	$ 1,291	$ 0	$ 0	N/A	N/A
% of revenues	1%	0%	0%		

Extraordinary gain on negative goodwill of $1,291,000 was arisen from the sequential acquisition of a company whose principal activities are the manufacturing and trading of rough and pre-formed gemstones (the Investee)

Pursuant to the purchase agreement dated January 1, 2005, the Company would pay US$2,827,500 to the Investee for the issuance of 3,900 new shares therein (Acquisition), in

which the Company had 20% equity interests. The Company then became the major stockholder holding 98% equity interests in the Investee, which became a subsidiary of the Company.

Inflation

We do not consider inflation to have had a material impact on our results of operations over the last three years.

Foreign Exchange

Approximately 97% of our sales are denominated in U.S. Dollars whereas the other sales are basically denominated in Hong Kong Dollars and Renminbi. The largest portion of our expenses are denominated in Hong Kong Dollars, followed by U.S. Dollars and Renminbi. The exchange rate of the Hong Kong Dollar is currently pegged to the U.S. Dollar, but during the past several years the market exchange rate has fluctuated within a narrow range. The Chinese government principally sets the exchange rate between the Renminbi and all other currencies. As a result, the exchange rates between the Renminbi and the U.S. Dollar and the Hong Kong Dollar have fluctuated in the past and may fluctuate in the future. If the value of the Renminbi or the Hong Kong Dollar decreases relative to the U.S. Dollar, such fluctuation may have a positive effect on the results of our operations. If the value of the Renminbi or the Hong Kong Dollar increases relative to the U.S. Dollar, such fluctuation may have a negative effect on the results of our operations. We do not currently hedge our foreign exchange positions.

Governmental economic and political policies and factors

For information regarding governmental economic, fiscal, monetary and political policies that could materially affect our operations, directly or indirectly, please refer to the Risk Factors section on pages 7 to 10.

B. LIQUIDITY AND CAPITAL RESOURCES.

We have no direct business operations other than the ownership of our subsidiaries and investment securities. Our ability to pay dividends and meet other obligations depends upon our receipt of dividends or other payments from our operating subsidiaries and investment securities.

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Cash Flows

(in thousands)	Years ended December 31, 2005	2004	2003
Net cash used in operating activities	$(14,222)	$(7,494)	$(3,571)
Net cash used in investing activities	(4,655)	(1,179)	(468)
Net cash provided by financing activities	20,450	9,179	5,764
Effect of foreign exchange rate change	(5)		
Net increase in cash and cash equivalents	1,568	506	1,725

Denominator: Denominator for basic earnings per share (weighted-average shares which reflect 356,441 shares in the treasury) 7,894,582 7,258,697 7,477,202 7,255,966 Effect of dilutive securities from restricted stock plan, from dilutive effect of stock options and warrants 27,815 74,300 53,435 65,621 Denominator for diluted earnings per share (adjusted weighted average shares) 7,922,397 7,332,997 7,530,637 7,321,587 Basic earnings per share $0.23 $0.21 $0.72 $0.41 Diluted earnings per share $0.23 $0.21 $0.71 $0.40

10. Derivative Instruments and Foreign Currency Exposure

The Company is exposed to foreign currency risk. Management has commenced a derivative instrument program to partially offset this risk by purchasing forward contracts to sell the Canadian Dollar and the Euro other than the cash flow hedge discussed below. Such contracts are largely timed to expire with the last day of the fiscal quarter, with a new contract purchased on the first day of the following quarter, to match the operating cycle of the Company. We designated the forward contracts as derivatives but not as hedging instruments, with loss and gain recognized in current earnings.

The Company accounts for its foreign exchange derivative instruments by recognizing all derivatives as either assets or liabilities at fair value, which may result in additional volatility in current period earnings or other comprehensive income, depending whether the instrument was designated as a cash flow hedge, as a result of recording recognized and unrecognized gains and losses from changes in the fair value of derivative instruments.

We have two types of derivatives to manage the risk of foreign currency fluctuations.

From time to time, we enter into forward contracts with financial institutions to manage our currency exposure related to net assets and liabilities denominated in foreign currencies. Those forward contract derivatives, not designated as hedging instruments, are generally settled quarterly. Gains and losses on those forward contracts are included in current earnings. There were no outstanding forward contracts at October 31, 2017 or January 31, 2017.

We may also enter into cash flow hedge contracts with financial institutions to manage our currency exposure on future cash payments denominated in foreign currencies. The effective portion of gain or loss on cash flow hedge is reported as a component of accumulated other comprehensive loss. The notional amount of these contracts was $0.8 million and $1.5 million at October 31, 2017 and January 31, 2017, respectively. The corresponding unrealized income or loss is recorded in the unaudited condensed consolidated statements of comprehensive income. The corresponding asset (liability) amounted to $(53,818) and $25,826 at October 31, 2017 and January 31, 2017, respectively.

11. Contingencies

Litigation:

The Company is involved in various litigation proceedings arising during the normal course of business which, in the opinion of the management of the Company, will not have a material effect on the Company's financial position, results of operations or cash flows; however, there can be no assurance as to the ultimate outcome of these matters. As of October 31, 2017, to the best of the Company's knowledge, there were no outstanding claims or litigation.

The Company's exit from Brazil:

Transfer of Shares Agreement

On July 31, 2015 (the "Closing Date"), Lakeland and Lake Brasil Industria E Comercio de Roupas E Equipamentos de Protecao Individual LTDA ("Lakeland Brazil"), completed a conditional closing of a Shares Transfer Agreement (the "Shares Transfer Agreement") with Zap Comércio de Brindes Corporativos Ltda ("Transferee"), a company owned by an existing Lakeland Brazil manager, entered into on June 19, 2015. Pursuant to the Shares Transfer Agreement, the Transferee has acquired all of the shares of Lakeland Brazil owned by the Company. The closing of this agreement was subject to Brazilian approval of the Shares transfer, which was received in October 2015.

The Company understands that under the laws of Brazil, a concept of fraudulent bankruptcy exists, which may hold a parent company liable for the liabilities of its Brazilian subsidiary in the event some level of fraud or misconduct is shown during the period that the parent company owned the subsidiary. While the Company believes that there has been no such fraud or misconduct relating to the proposed transfer of stock of Lakeland Brazil and the transactions contemplated by the Shares Transfer Agreement, as evidenced by the Company's funding support for continuing

operations of Lakeland Brazil, there can be no assurance that the courts of Brazil will not make such a finding nonetheless. The risk of exposure to the Company continues to diminish as the Transferee continues to operate Lakeland Brazil, as the risk of a finding of fraudulent bankruptcy lessens and pre-sale liabilities are paid off. Should the Transferee operate Lakeland Brazil for a period of two years, the Company believes the risk of a finding of fraudulent bankruptcy is eliminated.

VAT Tax Issues in Brazil

Value Added Tax ("VAT") in Brazil is charged at the state level. Lakeland Brazil has three pending VAT claims totaling R$1.3 million (USD $0.5 million) excluding interest, penalties and fees of R$2.7 million (USD $0.9 million), which our attorney informed us were likely to be successfully defended based on state auditor misunderstanding. Any liabilities hereunder are the responsibility of Lakeland Brazil which, as described above, is no longer owned by the Company.

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Labor Claims in Brazil

The Company may continue to be exposed to certain liabilities arising in connection with lawsuits pending in the labor courts in Brazil in which plaintiffs were seeking, as at July 31, 2015, a total of nearly USD $8,000,000 in damages from the Company's then Brazilian subsidiary (Lakeland Brazil). The Company believes many of these labor court claims are without merit and the amount of damages being sought is significantly higher than any damages which may have been incurred. Pursuant to the Shares Transfer Agreement, the Company is required to fully fund amounts owed by Lakeland Brazil in connection with the then existing labor claims and to pay amounts potentially owed for future labor claims up to an aggregate amount of $375,000 plus 60% of the excess of such amount until the earlier of (i) the date all labor claims against Lakeland Brazil deriving from events prior to the sale are settled, (ii) by our mutual agreement with Lakeland Brazil or (iii) on the two (2) year anniversary of closing of the sale. Although the two-year period has expired, the Company continues to support Lakeland Brazil in defending the remaining claims. While the vast majority of these labor suits have been resolved, there are four which remain active. In one such case a former employee of our former Brazilian subsidiary filed a counterclaim in the action seeking approximately USD $700,000 that he purports to be owed to him by our former Brazilian subsidiary under a purported promissory note and alleges that we are liable for payment therefor. Management firmly believes the counterclaim is without merit, intends to vigorously defend our position, and does not anticipate a negative outcome resulting in significant expense to us.

12*. Segment Reporting*

Domestic and international sales from continuing operations are as follows in millions of dollars:

	Three Months Ended October 31,				Nine Months Ended October 31,			
	2017		2016		2017		2016	
Domestic	$12.85	53.64 %	$11.26	48.45 %	$38.18	53.91 %	$35.24	53.49 %
International	11.11	46.36 %	11.98	51.55 %	32.65	46.09 %	30.64	46.51 %
Total	$23.96	100.00%	$23.24	100.00%	$70.83	100.00%	$65.88	100.00%

We manage our operations by evaluating each of our geographic locations. Our US operations include a facility in Alabama (primarily the distribution to customers of the bulk of our products and the light manufacturing of our chemical, wovens, reflective, and fire products). The Company also maintains one manufacturing company in China (primarily disposable and chemical suit production), a manufacturing facility in Mexico (primarily disposable, reflective, fire and chemical suit production) and a small manufacturing facility in India. Our China facilities produce the majority of the Company's products and China generates a significant portion of the Company's international revenues. We evaluate the performance of these entities based on operating profit, which is defined as income before income taxes, interest expense and other income and expenses. We have sales forces in the USA, Canada, Mexico, Europe, Latin America, India, Russia, Kazakhstan and China, which sell and distribute products shipped from the United States, Mexico, India or China. The table below represents information about reported segments for the periods noted therein:

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	Three Months Ended October 31, (in millions of dollars)		**Nine Months Ended October 31, (in millions of dollars)**	
	2017	2016	2017	2016
Net Sales:				
USA	$ 14.16	$ 12.75	$ 41.46	$ 38.09
Other foreign	4.94	5.34	13.66	12.25
Europe (UK)	2.24	1.90	6.46	6.95
Mexico	0.90	0.84	2.77	2.42
China	13.47	10.41	36.88	30.37
Corporate	0.45	0.27	0.98	1.44
Less intersegment sales	(12.20)	(8.27)	(31.38)	(25.64)
Consolidated sales	$ 23.96	$ 23.24	$ 70.83	$ 65.88
External Sales:				
USA	$ 12.85	$ 11.26	$ 38.18	$ 35.24
Other foreign	4.39	5.09	12.47	11.49
Europe (UK)	2.24	1.90	6.42	6.95
Mexico	0.51	0.40	1.66	1.13
China	3.97	4.59	12.10	11.07
Consolidated external sales	$ 23.96	$ 23.24	$ 70.83	$ 65.88
Intersegment Sales:				
USA	$ 1.31	$ 1.49	$ 3.28	$ 2.85
Other foreign	0.55	0.25	1.19	0.76
Europe (UK)	—	—	0.04	—
Mexico	0.39	0.44	1.11	1.29
China	9.50	5.82	24.78	19.30
Corporate	0.45	0.27	0.98	1.44
Consolidated intersegment sales	$ 12.20	$ 8.27	$ 31.38	$ 25.64

	Three Months Ended October 31, (in millions of dollars)		Nine Months Ended October 31, (in millions of dollars)	
	2017	2016	2017	2016
Operating Profit (Loss):				
USA	$ 2.62	$ 1.58	$ 7.40	$ 5.62
Other foreign	0.92	0.81	2.04	1.36
Europe (UK)	(0.02)	0.01	0.09	0.29
Mexico	(0.06)	0.04	(0.02)	0.05
China	0.66	1.37	2.21	3.15
Corporate	(1.46)	(1.60)	(4.56)	(5.56)
Less intersegment profit (loss)	0.01	0.03	0.16	0.09
Consolidated operating profit	$ 2.67	$ 2.25	$ 7.32	$ 5.00
Depreciation and Amortization Expense:				
USA	$ 0.03	$ 0.04	$ 0.09	$ 0.12
Other foreign	0.04	0.03	0.10	0.11
Europe (UK)	—	—	0.01	—
Mexico	0.03	0.03	0.09	0.09
China	0.06	0.08	0.19	0.25
Corporate	0.05	0.14	0.14	0.43
Less intersegment	(0.01)	0.04	(0.04)	(0.04)
Consolidated depreciation & amortization expense	$ 0.20	$ 0.36	$ 0.58	$ 0.96
Interest Expense:				
USA (shown in Corporate)	$ —	$ —	$ —	$ —
Other foreign	0.02	0.02	0.05	0.08
Europe (UK)	0.01	—	0.01	—
Mexico	—	—	—	—
China	—	0.04	—	0.12
Corporate	0.01	0.09	0.09	0.32
Less intersegment	—	—	—	—
Consolidated interest expense	$ 0.04	$ 0.15	$ 0.15	$ 0.52
Income Tax Expense (Benefits):				
USA (shown in Corporate)	$ —	$ —	$ —	$ —
Other foreign	0.16	0.16	0.42	0.27
Europe (UK)	0.01	0.01	0.05	0.04
Mexico	—	—	—	—
China	0.12	0.36	0.50	0.81
Corporate	0.55	0.04	0.83	0.41
Less intersegment	(0.01)	0.01	0.03	0.02
Consolidated income tax expense	$ 0.83	$ 0.58	$ 1.83	$ 1.55
Capital Expenditures:				
USA	$ 0.01	$ 0.02	$ 0.02	$ 0.02
Other foreign	—	(0.01)	—	—
Europe (UK)	—	—	—	—
Mexico	0.03	—	0.06	—

China	0.01	0.01	0.07	0.03
India	0.06	—	0.08	0.02
Corporate	0.06	0.05	0.39	0.05
Consolidated capital expenditures	$ 0.17	$ 0.07	$ 0.62	$ 0.12

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	October 31, 2017 (in millions of dollars)	January 31, 2017 (in millions of dollars)
Total Assets:*		
USA	$ 63.84	$ 56.34
Other foreign	21.17	18.16
Europe (UK)	4.65	3.61
Mexico	4.38	3.99
China	36.94	30.54
India	(1.10)	(1.36)
Corporate	29.40	26.00
Less intersegment	(58.92)	(52.73)
Consolidated assets	$ 100.36	$ 84.55
Total Assets Less Intersegment:*		
USA	$ 29.88	$ 30.94
Other foreign	12.87	10.17
Europe (UK)	4.65	3.58
Mexico	4.46	4.07
China	21.33	18.44
India	0.84	0.43
Corporate	26.33	16.92
Consolidated assets	$ 100.36	$ 84.55
Property and Equipment:		
USA	$ 2.01	$ 2.09
Other foreign	1.46	1.55
Europe (UK)	0.03	0.03
Mexico	2.02	2.05
China	1.93	2.05
India	0.10	0.03
Corporate	1.05	0.75
Less intersegment	0.02	(0.02)
Consolidated property and equipment	$ 8.62	$ 8.53
Goodwill:		
USA	$ 0.87	$ 0.87
Consolidated goodwill	$ 0.87	$ 0.87

*Negative assets reflect intersegment amounts eliminated in consolidation

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

This Form 10-Q may contain certain "forward-looking" information within the meaning of the Private Securities Litigation Reform Act of 1995. This information involves risks and uncertainties. Our actual results may differ materially from the results discussed in the forward-looking statements. See "SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS" at the beginning of Part I, Item 1.

Based on our closing stock price as reported by The NASDAQ Global Market on July 31, 2017, starting with our next Annual Report on Form 10-K, we will transition to an "accelerated filer" under Rule 12b-2 of the Securities Exchange Act of 1934, and, as such, be required to obtain audits of our internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act of 2002 and meet accelerated deadlines for financial reporting.

Overview

We manufacture and sell a comprehensive line of safety garments and accessories for the industrial and public protective clothing market. Our products are sold by our in-house customer service group, our regional sales managers and independent sales representatives to a network of over 1,200 North American safety and mill supply distributors. These distributors in turn supply end user industrial customers, such as integrated oil, chemical/petrochemical, utilities, automobile, steel, glass, construction, smelting, munition plants, janitorial, pharmaceutical, mortuaries and high technology electronics manufacturers, as well as scientific and medical laboratories. In addition, we supply federal, state and local governmental agencies and departments, such as fire and law enforcement, airport crash rescue units, the Department of Defense, the Department of Homeland Security and the Centers for Disease Control. Internationally, sales are to a mixture of end users directly and to industrial distributors depending on the particular country market. Sales are made to more than 40 foreign countries but are primarily in China, European Economic Community ("EEC"), Canada, Chile, Argentina, Russia, Colombia, Mexico, Ecuador and Southeast Asia.

We have operated facilities in Mexico since 1995 and in China since 1996. Beginning in 1995, we moved the labor intensive sewing operation for our limited use/disposable protective clothing lines to these facilities. Our facilities and capabilities in China and Mexico allow access to a less expensive labor pool than is available in the United States and permit us to purchase certain raw materials at a lower cost than they are available domestically. As we have increasingly moved production of our products to our facilities in Mexico and China, we have seen improvements in the profit margins for these products. Our net sales attributable to customers outside the United States were $11.1 million and $12.0 million for the three months and $32.7 million and $30.6 million for the nine months ended October 31, 2017 and 2016, respectively.

Critical Accounting Policies and Estimates

Our discussion and analysis of our financial condition and results of operations are based upon our unaudited condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America ("US GAAP"). The preparation of our unaudited condensed consolidated financial statements in conformity with US GAAP requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, net sales and expenses and disclosure of contingent assets and liabilities. We base our estimates on the past experience and on various other assumptions that we believe to be reasonable under the circumstances, and we periodically evaluate these estimates.

We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our unaudited condensed consolidated financial statements.

Revenue Recognition

The Company derives its sales primarily from its limited use/disposable protective clothing and secondarily from its sales of high-end chemical protective suits, firefighting and heat protective apparel, gloves and arm guards and reusable woven garments. Sales are recognized when goods are shipped, at which time title and the risk of loss pass to the customer. Sales are reduced for sales returns and allowances. Payment terms are generally net 30 days for United States sales and net 90 days for international sales.

Substantially, all the Company's sales are made through distributors. There are no significant differences across product lines or customers in different geographical areas in the manner in which the Company's sales are made.

Lakeland offers a growth rebate to certain distributors each year on a calendar-year basis. Sales are tracked on a monthly basis, and accruals are based on sales growth over the prior year. The growth rebate accrual is adjusted either up or down on a monthly basis as a reduction (increase) to revenue and an increase (reduction) to the accrual based on monthly sales trends as compared with prior year. Based on volume and products purchased, distributors can earn anywhere from 1% to 6% rebates in the form of either a quarterly or annual credit to their account, depending on the specific agreement. In estimating the accrual needed, management tracks sales growth over the prior year.

Our sales are generally final; however, requests for return of goods can be made and must be received within 90 days from invoice date. No returns will be accepted without a written authorization. Return products may be subject to a restocking charge and must be shipped freight prepaid. Any special made-to-order items are not returnable. Customer returns have historically been insignificant.

Customer pricing is subject to change on a 30-day notice; exceptions based on meeting competitors' pricing are considered on a case-by-case basis. Revenue is recorded net of taxes collected from customers. The related taxes that are remitted to governmental authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

For larger orders, except in its Lakeland Fire product line, the Company absorbs the cost of shipping and handling. For those customers who are billed the cost of shipping and handling fees, such amounts are included in net sales.

Accounts Receivable, net

Trade accounts receivable are stated at the amount the Company expects to collect. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability of its customers to make required payments. The Company recognizes losses when information available indicates that it is probable that a receivable has been impaired based on criteria noted above at the date of the consolidated financial statements, and the amount of the loss can be reasonably estimated. Management considers the following factors when determining the collectability of specific customer accounts: customer creditworthiness, past transaction history with the customers, current economic industry trends and changes in customer payment terms. Past due balances over 90 days and other less creditworthy accounts are reviewed individually for collectability. If the financial condition of the Company's customers were to deteriorate, adversely affecting their ability to make payments, additional allowances would be required. Based on management's assessment, the Company provides for estimated uncollectible amounts through a charge to earnings and a credit to a valuation allowance. Balances that remain outstanding after the Company has used reasonable collection efforts are written off through a charge to the valuation allowance and a credit to accounts

receivable.

Inventories, net

Inventories include freight-in, materials, labor and overhead costs and are stated at the lower of cost (on a first-in, first-out basis) or net realizable value. Provision is made for slow-moving, obsolete or unusable inventory.

Goodwill

Goodwill represents the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized. Goodwill is evaluated for impairment at least annually; however, this evaluation may be performed more frequently when events or changes in circumstances indicate the carrying amount may not be recoverable. Factors that the Company considers important that could identify a potential impairment include: significant changes in the overall business strategy and significant negative industry or economic trends. The Company measures any potential impairment on a projected discounted cash flow method. Estimating future cash flows requires the Company’s management to make projections that can differ materially from actual results. As of October 31, 2017 and January 31, 2017, no impairment was recorded.

Impairment of Long-Lived Assets

The Company evaluates the carrying value of long-lived assets to be held and used when events or changes in circumstances indicate the carrying value may not be recoverable. The Company measures any potential impairment on a projected undiscounted cash flow method. Estimating future cash flows requires the Company's management to make projections that can differ materially from actual results. The carrying value of a long-lived asset is considered impaired when the total projected undiscounted cash flows from the asset is less than its carrying value. In that event, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the long-lived asset. As of October 31, 2017 and January 31, 2017, no impairment was recorded.

Income Taxes

The Company is required to estimate its income taxes in each of the jurisdictions in which it operates as part of preparing the unaudited condensed consolidated financial statements. This involves estimating the actual current tax in addition to assessing temporary differences resulting from differing treatments for tax and financial accounting purposes. These differences, together with net operating loss carryforwards and tax credits, are recorded as deferred tax assets or liabilities on the Company's unaudited condensed consolidated balance sheet. A judgment must then be made of the likelihood that any deferred tax assets will be recovered from future taxable income. A valuation allowance may be required to reduce deferred tax assets to the amount that is more likely than not to be realized. In the event the Company determines that it may not be able to realize all or part of its deferred tax asset in the future, or that new estimates indicate that a previously recorded valuation allowance is no longer required, an adjustment to the deferred tax asset is charged or credited to income in the period of such determination.

The Company recognizes tax positions that meet a "more likely than not" minimum recognition threshold. If necessary, the Company recognized interest and penalties associated with tax matters as part of the income tax provision and would include accrued interest and penalties with the related tax liability in the unaudited condensed consolidated balance sheets.

Foreign Operations and Foreign Currency Translation

The Company maintains manufacturing operations in Mexico, Argentina, India, and the People's Republic of China and can access independent contractors in Mexico, Argentina and China. It also maintains sales and distribution entities located in India, Canada, the U.K., Chile, China, Argentina, Russia, Kazakhstan and Mexico. The Company is vulnerable to currency risks in these countries. The functional currency for the United Kingdom subsidiary is the Euro; the trading company in China, the RMB; the Canadian Real Estate subsidiary, the Canadian dollar; and the Russian operation, the Russian Ruble and Kazakhstan Tenge. All other operations have the US dollar as its functional currency.

Pursuant to US GAAP, assets and liabilities of the Company's foreign operations with functional currencies, other than the US dollar, are translated at the exchange rate in effect at the balance sheet date, while revenues and expenses are translated at average rates prevailing during the periods. Translation adjustments are reported in accumulated other comprehensive loss, a separate component of stockholders' equity. Cash flows are also translated at average translation rates for the periods, therefore, amounts reported on the statement of cash flows will not necessarily agree with changes in the corresponding balances on the unaudited condensed consolidated balance sheet. Transaction gains and losses that arise from exchange rate fluctuations on transactions denominated in a currency other than the functional currency are included in the results of operations as incurred.

Fair Value of Financial Instruments

US GAAP defines fair value, provides guidance for measuring fair value and requires certain disclosures utilizing a fair value hierarchy which is categorized into three levels based on the inputs to the valuation techniques used to measure fair value.

The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs that reflect management's own assumptions.

Foreign currency forward and hedge contracts are recorded in the unaudited condensed consolidated balance sheets at their fair value as of the balance sheet dates based on current market rates as further discussed in the unaudited condensed consolidated financial statements.

The financial instruments of the Company classified as current assets or liabilities, including cash and cash equivalents, accounts receivable, short-term borrowings, borrowings under the revolving credit facility, accounts payable and accrued expenses, are recorded at carrying value, which approximates fair value based on the short-term nature of these instruments.

The Company believes that the fair values of its long-term debt approximates its carrying value based on the effective interest rate compared to the current market rate available to the Company.

Recent Accounting Pronouncements

See Note 3 in the unaudited condensed consolidated financial statements for management's periodic review of new accounting standards that were issued.

Significant Balance Sheet Fluctuation October 31, 2017, As Compared to January 31, 2017

Balance Sheet Accounts. Cash increased by $11.1 million in the nine-month period ended October 31, 2017 as a result of the Company's public offering in the third quarter of fiscal 2018 fully described in Note 7, accounts payable increased $3.6 million and inventory net of reserves increased $2.9 million as the Company replenished stock of core product while managing high levels of back orders. The Company's borrowings under the revolving credit facility decreased $4.9 million further reducing debt as the Company continues to reduce costs, and accounts receivable increased $2.3 million as sales volume remains strong in the nine months ended October 31, 2017.

Three Months ended October 31, 2017, As Compared to the Three Months Ended October 31, 2016

Net Sales. Net sales increased to $24.0 million for the three months ended October 31, 2017 compared to $23.2 million for the three months ended October 31, 2016, an increase of 3.1%. Sales in the USA increased $1.6 million or 12.2% due primarily to increased disposables sales to national accounts and in response to hurricane clean-up efforts, and to increased sales in the chemical line into oil field service companies and refinery operations as the US economy continues to improve. USA sales of disposables increased $1.2 million, chemicals increased $0.5 million, sales of wovens products increased $0.1 million and sales of gloves increased $0.1 million. Sales of reflective products remained level at $2.1 million and sales of fire products decreased $0.5 million as there were large order in the comparison period last year that did not repeat during the three months ended October 31, 2017. The increase in wovens sales is mostly due to focused penetration of fire retardant "FR" cotton coveralls into the pipeline industry where activity is increasing. Sales in China and to the Asia Pacific Rim increased $3.1 million or 29.4% as industrial activity improved and several larger customers began replacing depleted inventories and as intercompany demand increased and the Company worked through a large backlog. Canada sales increased $0.4 million as that country continues to experience an oil and gas turnaround requiring protective wear and as some customers replenished their stock in response to higher than forecasted demand at higher price points. UK sales increased by $0.3 million or 18.3% as new distributors placed stocking orders. Russia and Kazakhstan sales combined increased $0.3 million or 102.6%, and Latin America sales remain strong at $1.8 million in a continuously improving economy even though compared to the same period in the prior year it is a decrease of 39.8% due to a large sale to Ecuador in the comparison period.

Gross Profit. Gross profit increased $0.5 million, or 6.3%, to $9.1 million for the three months ended October 31, 2017, from $8.5 million for the three months ended October 31, 2016. Gross profit as a percentage of net sales increased to 37.8% for the three-month period ended October 31, 2017, from 36.6% for the three months ended October 31, 2016. Gross margin increases were somewhat offset by labor increases in our manufacturing facilities due to wage increases and overtime associated with relieving the stress in the Company's internal supply chain. Major factors driving gross margins were:

- Disposables gross margins increased 4.6 percentage points due to product mix and increased volume.
- Chemical gross margin increased by 7.5 percentage points primarily due to a reduction in force in the USA to move production to our more cost effective facilities in Mexico and China during Q1FY17 which resulted in improved manufacturing cost, improved volume and sales of higher volume products.
- Fire protection gross margin decreased 2.5 percentage points as the Company prepares for the upcoming change to the National Fire Protection Agency ("NFPA") standards by discounting products produced under the old standard and due to product mix.
- Wovens gross margins increased 18.0 percentage points due to market price increases on contractor FR coveralls.
- Reflective gross margins increased 14.3 percentage points as a result of increased pricing on some products and the product mix.
- UK gross margins increased 5.9 percentage points as a result of increased sales of a higher margin chemical cool suit.
- Chile's gross margin increased 18.8 percentage points as sales of FR garments into the industrial category rebounded and Argentina's gross margin decreased 16.8 percentage points primarily as compared to the prior year period where a large sale into Ecuador had particularly strong margins.

Operating expenses. Operating expense increased 3.1% from $6.3 million for the three months ended October 31, 2016 to $6.4 million for the three months ended October 31, 2017. Operating expense as a percentage of net sales was 26.7% for the three months ended October 31, 2017 and 2016. The main factors for the increase in operating expenses are a $0.1 million increase in sales salaries as the Company continues to grow its sales force, an increase of $0.2 million to freight out as a result of rush shipments associated with the backlog as well as freight line price increases, and increase of $0.2 million to bad debt resulting from an increase to the accounts receivable allowance for several customers that are slow paying and offset by a $0.4 million decrease to commissions as a result of a large sale in Argentina in the same period last year and a $0.1 million decrease in officer salaries resulting from the reduction of one officer due to retirement.

Operating Profit. Operating profit increased to $2.7 million for the three months ended October 31, 2017, from $2.3 million for the three months ended October 31, 2016, as most operating expenses are fixed in nature other than commissions and freight out and sales volume increased as compared to the three months ended October 31, 2016. Operating margins were 11.1% for the three months ended October 31, 2017, compared to 9.7% for the three months ended October 31, 2016 and were impacted by the items highlighted in gross profit and operating expenses.

Interest Expense. Interest expense decreased to $0.1 million for the three months ended October 31, 2017 from $0.2 million for the three months ended October 31, 2016 as the Company utilized lower interest rates from its revolving

credit facility and reduced borrowings for the three months ended October 31, 2017, primarily as a result of greater profitability and proceeds from the Company's public offering.

Income Tax Expense. Income tax expense consists of federal, state and foreign income taxes. Income tax expense was $0.8 million for the three months ended October 31, 2017, as compared to an income tax expense of $0.6 million for the three months ended October 31, 2016. The increase in tax expense was a result of significantly higher operating income in the US during the three months ended October 31, 2017 as well as overall improved profitability.

Net Income. Net income increased to $1.8 million for the three months ended October 31, 2017 from $1.5 million for the three months ended October 31, 2016. The results for three months ended October 31, 2017 are primarily due to continuing cost containment efforts and increases in sales volume as the industrial sector showed marked performance improvements and the global economy improved.

Nine Months ended October 31, 2017, As Compared to the Nine Months Ended October 31, 2016

Net Sales. Net sales increased to $70.8 million for the nine months ended October 31, 2017 compared to $65.9 million for the nine months ended October 31, 2016, an increase of 7.5%. Sales in the USA increased $3.0 million or 7.4% due primarily to increased sales in the chemical and disposables channels. USA sales of disposables increased $1.8 million or 9.1%, sales in the chemicals line increased $0.7 million or 16.1%, sales of fire gear increased $0.4 million or 9.7 %, sales of wovens increased $0.4 million or 16.4% and reflective and glove sales were mostly level at $5.9 million and $2.0 million respectively. Wovens and fire protection sales combined increased $0.8 million or 12.2% mostly due to focused penetration with strategic fire distributors who support and market our fire gear and increased sales of FR cotton coveralls into the pipeline industry where activity is increasing. Sales in China and to the Asia Pacific Rim increased $6.5 million or 21.4% as industrial activity improved and several larger customers began replacing depleted inventories and as intercompany demand increased. Canada sales increased $0.6 million as that country continues to experience an oil and gas turnaround requiring protective wear. UK sales decreased by $0.5 million or 7.1% mostly due to uncertainty in the economy as a result of Brexit, continuing currency challenges and a strategic decision by the Company to exit two private label businesses in Europe. Russia and Kazakhstan sales combined increased $0.5 million or 49.6%, and Latin America sales increased $0.1 million or 2.0% due to resolution of supply chain issues and an overall increase in industrial activity even as compared to last year which included a large Ecuador sale, respectively.

Gross Profit. Gross profit increased $2.4 million, or 10.1%, to $26.3 million for the nine months ended October 31, 2017, from $23.9 million for the nine months ended October 31, 2016. Gross profit as a percentage of net sales increased to 37.1% for the nine-month period ended October 31, 2017, from 36.3% for the nine months ended October 31, 2016. Gross margin increases were somewhat offset by labor increases in our manufacturing facilities due to wage increases and overtime associated with relieving the stress in the Company's internal supply chain. Major factors driving gross margins were:

- Chemical gross margin increased by 6.2 percentage points primarily due to a reduction in force in the USA to move production to our more cost effective facilities in Mexico and China during Q1FY17 which resulted in severance payments in that quarter, improved volume and product mix.
- Disposables margins increased 1.5 percentage points as volume increased and sales of higher margin cleanroom products began to get traction.
- Fire protection gross margin increased 2.8 percentage points due to a reduction in force in the USA to move production to our more cost effective facility in Mexico in Q1FY17, better margins associated with fire distributors in the industrial market, and improved volume.
- Wovens gross margins increased 8.7 percentage points as the Company increased sales of higher margin FR products into the pipeline industry in Q1FY18.
- Glove margins increased 8.8 percentage points due to product mix.
- Reflective gross margins increased 5.8 percentage points as a result of product mix and price increases for some products.
- Chile's gross margin increased 11.3 percentage points as sales into the industrial category rebounded and Argentina's gross margin decreased 9.1 percentage points primarily due to a shift in the product mix.
- Canada's gross margins increased 9.5 percentage points as a result of product mix, increased volume and currency tailwinds.

Operating expenses. Operating expense were up slightly at $19.0 million for the nine months ended October 31, 2017 as compared to $18.9 million for the nine months ended October 31, 2016. Operating expense as a percentage of net sales was 26.8% for the nine months ended October 31, 2017 down from 28.7% for the nine months ended October 31, 2016. The main factors for the increase in operating expenses are a $0.3 million increase in sales salaries as the Company continues to grow its sales force, an increase of $0.2 million to freight out as a result of rush shipments associated with the backlog as well as freight line price increases, an increase of $0.2 million to utilities as a normal course of business, an increase of $0.1 million to bad debt resulting from an increase to the accounts receivable allowance for several customers that are slow paying, an increase to currency fluctuation of $0.2 million in the normal course of business, and an increase to professional fees of $0.1 million from various legal and accounting work and the public offering fully described in the accompanying unaudited condensed consolidated financial statements offset by a $0.3 million decrease to commissions as a result of a large sale in Argentina in the same period last year, a $0.2 million decrease to payroll administration due to a severance accrual in the prior reporting period, a $0.2 million decrease to depreciation in the normal course of business, and a $0.4 million decrease in officer salaries resulting from the reduction of one officer due to retirement.

Operating Profit. Operating profit increased to $7.3 million for the nine months ended October 31, 2017, from $5.0 million for the nine months ended October 31, 2016, mainly as a result of stronger sales volume and the fixed nature of most operating expenses other than commissions and freight out. Operating margins were 10.3% for the nine months ended October 31, 2017, compared to 7.6% for the nine months ended October 31, 2016.

Interest Expense. Interest expense decreased to $0.1 million for the nine months ended October 31, 2017 from $0.5 million for the nine months ended October 31, 2016 as the Company utilized lower interest rates from their revolving credit facility and reduced borrowings for the nine months ended October 31, 2017, primarily as a result of greater profitability, a reduction in inventory levels, and a public offering.

Income Tax Expense. Income tax expense consists of federal, state and foreign income taxes. Income tax expense for the nine months ended October 31, 2017 was $1.8 million and $1.5 million for the nine months ended October 31, 2016. Profitability was higher in Q3 this year vs. Q3 of last year.

Net Income. Net income increased to $5.4 million for the nine months ended October 31, 2017 from $2.9 million for the nine months ended October 31, 2016. The results for nine months ended October 31, 2017 are primarily due to higher sales volume than in the prior fiscal year as well as continuing cost containment efforts, increases in sales volume.

Liquidity and Capital Resources

As of October 31, 2017, we had cash and cash equivalents of approximately $21.5 million and working capital of $64.7 million. Cash and cash equivalents increased $11.1 million and working capital increased $17.0 million from January 31, 2017 as the Company consummated a capital raise and continued cost containment efforts. International cash management is affected by local requirements and movements of cash across borders can be slowed down significantly. We believe that based upon our current cash position and projected future revenue, we will have sufficient cash to fund our operations for the next twelve months.

Of the Company's total cash and cash equivalents of $21.5 million as of October 31, 2017, cash held in the UK of $0.1 million and cash held in India of $0.1 million would not be subject to additional tax as foreign income related thereto has already been subject to US tax. Cash held in Canada of $0.9 million as of October 31, 2017 could be subject to US tax as a result of the change in our financing arrangement. Cash in all other foreign countries of $9.3 million would incur US tax less any foreign tax credits if the cash was repatriated. In the event that the Company repatriated cash from China, of the $8.3 million balance at October 31, 2017 there would be an additional 10% withholding tax incurred in that country. The Company has strategically employed a dividend plan subject to declaration and certain approvals in which its Canadian subsidiary sends dividends to the US in the amount of 100% of the previous year's earnings, the UK subsidiary sends dividends to the US in the amount of 50% of the previous year's earnings, and the

Weifang China subsidiary of the Company sends dividends to the US in declared amounts of the previous year's earnings. Dividends were not declared for our China subsidiary in the first three quarters of FY18 or for the year ended FY17 as management evaluates the possible impact of regulatory changes in the US tax code.

Net cash provided by operating activities of $5.5 million for the nine months ended October 31, 2017 was primarily due to net income of $5.4 million and an increase in accounts payable of $3.5 million, offset by an increase in accounts receivable of $2.1 million and an increase in inventories of $3.0 million. Net cash provided by financing activities of $6.2 million was the result of the equity raise which generated $10.1 million, an increase in long term borrowings of $1.6 million and an increase to UK and short term borrowings of $0.6 million, offset by an increase in repayments under our revolving credit facility of $4.9 million and short term and longer term repayments of $0.9 million.

Stock Repurchase Program. On July 19, 2016, the Company's board of directors approved a stock repurchase program under which the Company may repurchase up to $2,500,000 of its outstanding common stock. The Company has not repurchased any stock under this program as of the date of this filing.

Capital Expenditures. Our capital expenditures through Q3FY18 of $0.6 million principally relate to additions to equipment in China and manufacturing equipment, computer system and leasehold improvements in the USA. We anticipate FY18 capital expenditures to be approximately $1.2 million as there is a new ERP project underway.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Foreign Currency Risk

While as a smaller reporting company, disclosure of market risk is not required, the Company is voluntarily including such disclosures.

We are exposed to changes in foreign currency exchange rates as a result of our purchases and sales in other countries. To manage the volatility relating to foreign currency exchange rates, we seek to limit, to the extent possible, our non-US dollar denominated purchases and sales.

In connection with our operations in China, we purchase a significant amount of products from outside of the United States. However, our purchases in China are primarily made in Chinese RMB, the value of which had been largely pegged to the US dollar for the last decade. However, the Chinese RMB has been decoupled from the US Dollar and allowed to float by the Chinese government and, therefore, we have been exposed to additional foreign exchange rate risk on our Chinese raw material and component purchases.

Our primary risk from foreign currency exchange rate changes is presently related to non-US dollar denominated sales in Canada, Europe and in South American countries. Our sales to customers in Canada are denominated in Canadian dollars and in Europe in Euros and British pounds. If the value of the US dollar increases relative to the Canadian dollar, the Pound or the Euro, then our net sales could decrease as our products would be more expensive to these international customers because of changes in rate of exchange. Our sales from China are denominated in the Chinese RMB and US dollars. We manage the foreign currency risk through the use of rolling 90-day forward contracts against the Canadian dollar and the Euro and through longer term cash flow hedges in the US against the Euro. We do not hedge other currencies at this time. In the event that a non-US dollar denominated international purchases and sales grow, exposure to volatility in exchange rates could have a material adverse impact on our financial results. The only significant unhedged foreign exchange exposure we have is the Argentine peso. Other unhedged currency exposure is not significant. If the Argentina exchange rate varied either way by +/- 10%, it would not be significant so

long as prices could be raised to account for more expensive garments.

Interest Rate Risk

We are exposed to interest rate risk with respect to our credit facilities, which have variable interest rates based upon the London Interbank Offered Rate. At October 31, 2017, we had approximately $1.5 million in borrowings outstanding under our bank credit facility. If the interest rate applicable to this variable rate debt rose 1% in the year ended January 31, 2018, our interest expense would have increased $0.2 million.

Tax Risks

We are exposed to tax rate risk with respect to our deferred tax asset. Should the effective tax rate decrease as a result of tax reform there could be a significant one-time noncash charge to earnings in order to adjust our deferred tax asset. Though this one-time adjustment might be material, the Company would be in a favorable tax position going forward.

The Company claimed a worthless stock deduction in connection with our exit from Brazil which has generated a tax benefit of approximately US $9.5 million. While, along with our tax advisors, we believe that this deduction is valid, there can be no assurance that the IRS will not challenge it and, if challenged, there is no assurance that the Company will prevail.

Risks Associated with Discontinued Foreign Operations.

During the fiscal year ended January 31, 2016 the Company formally executed its exit from Brazil, but we may continue to be exposed to certain liabilities arising in connection with the prior operations of Lakeland Brazil. These risks include but are not limited to pre-existing VAT claims in the amount of $0.5 million excluding interest, penalties and fees and outstanding labor claims totaling approximately $0.3 million as of and at the quarter ended October 31, 2017. The Company understands that under the laws of Brazil, a concept of fraudulent bankruptcy exists, which may hold a parent company liable for the liabilities of a former Brazilian subsidiary in the event some level of fraud or misconduct is shown during the period that the parent company owned the subsidiary. While the Company believes that there has been no such fraud or misconduct relating to operations of and their exit from Brazil, there can be no assurance that the courts of Brazil will not make such a finding. The risk of exposure to the Company continues to diminish as the former subsidiary continues to operate, as the risk of a finding of fraudulent bankruptcy lessens and pre-sale liabilities are paid off. Should the former subsidiary stay in operations for a period of two years, the Company believes the risk of a finding of fraudulent bankruptcy is eliminated.

As disclosed in our periodic filings with the SEC, we agreed to make certain payments in connection with ongoing labor litigation involving our former Brazilian subsidiary. While the vast majority of these labor suits have been resolved, there are four which remain active. In one such case a former employee of our former Brazilian subsidiary recently filed a counterclaim in the action seeking approximately US $700,000 that he purports to be owed to him by our former Brazilian subsidiary under a purported promissory note and alleges that we are liable for payment therefore. Management firmly believes the counterclaim is without merit, intends to vigorously defend our position, and does not anticipate a negative outcome resulting in significant expense to us.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We conducted an evaluation, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of our disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act") as of October 31, 2017. There are inherent limitations to the effectiveness of any system of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective disclosure controls and procedures can only provide reasonable assurance of achieving their control objectives. Based on their evaluation, the Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of October 31, 2017.

Changes in Internal Control over Financial Reporting

There have been no changes that occurred during Lakeland's third quarter of fiscal 2018 which materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II. OTHER INFORMATION

Items 1, 1A, 2, 3, 4 and 5 are not applicable

Item 6. **Exhibits**:

Exhibits:

31.1* Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2* Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1* Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2* Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

101.INS* XBRL instance Document
101.SCH* XBRL Taxonomy Extension Schema Document
101.CAL* XBRL Taxonomy Extension Definitions Document
101.DEF* XBRL Taxonomy Extension Labels Document
101.LAB* XBRL Taxonomy Extension Labels Document
101.PRE* XBRL Taxonomy Extension Presentations Document

* Filed herewith

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

	LAKELAND INDUSTRIES, INC. (Registrant)
Date: December 15, 2017	*/s/ Christopher J. Ryan* Christopher J. Ryan, Chief Executive Officer, President and Secretary (Principal Executive Officer and Authorized Signatory)
Date: December 15, 2017	*/s/ Teri W. Hunt* Teri W. Hunt, Chief Financial Officer (Principal Accounting Officer and Authorized Signatory)

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