

CHARLOTTE RUSSE HOLDING INC

Form 10-Q

January 23, 2006

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**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

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**FORM 10-Q**

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

**FOR THE QUARTERLY PERIOD ENDED DECEMBER 24, 2005**

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

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**COMMISSION FILE NUMBER 000-27677**

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**CHARLOTTE RUSSE HOLDING, INC.**

**(Exact Name of Registrant as Specified in Its Charter)**

**DELAWARE**  
**(State or Other Jurisdiction of Incorporation)**

**33-0724325**  
**(I.R.S. Employer Identification No.)**

**4645 MORENA BOULEVARD**  
**SAN DIEGO, CA**

**92117**  
**(Address, including Zip Code, of Registrant's Principal Executive Offices)**

**(858) 587-1500**

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(Registrant's Telephone Number, Including Area Code)

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indicate by check mark if the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act): Yes ☐ No ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

The number of shares of common stock outstanding as of January 13, 2006 was approximately 22,432,166.

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CHARLOTTE RUSSE HOLDING, INC.

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## CHARLOTTE RUSSE HOLDING, INC.

## CONSOLIDATED BALANCE SHEETS

	December 24, 2005	September 24, 2005
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 60,079,150	\$ 33,693,158
Inventories	51,746,183	58,087,482
Other current assets	8,037,534	11,090,971
Deferred tax assets	7,800,000	7,450,000
Total current assets	127,662,867	110,321,611
Fixed assets, net	190,559,329	188,629,728
Goodwill	28,790,000	28,790,000
Other assets	1,311,600	1,394,340
Total assets	\$ 348,323,796	\$ 329,135,679
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable, trade	\$ 26,415,147	\$ 33,581,612
Accounts payable, other	8,312,074	6,776,763
Accrued payroll and related expense	7,251,298	3,554,097
Income and sales taxes payable	7,177,584	3,095,810
Other current liabilities	17,776,938	11,644,718
Total current liabilities	66,933,041	58,653,000
Deferred rent	103,257,845	101,888,551
Other liabilities	43,894	43,894
Deferred tax liabilities	1,300,000	1,440,000
Total liabilities	171,534,780	162,025,445
Commitments and contingencies		
Stockholders' equity:		
Preferred Stock \$0.01 par value, 3,000,000 shares authorized, none issued and outstanding		
Common Stock \$0.01 par value, 100,000,000 shares authorized, issued and outstanding shares 22,421,652 and 22,037,432 at December 24, 2005 and September 24, 2005, respectively.	224,217	220,375
Additional paid-in capital	53,340,724	50,724,713
Retained earnings	123,224,075	116,165,146
Total stockholders' equity	176,789,016	167,110,234
Total liabilities and stockholders' equity	\$ 348,323,796	\$ 329,135,679

See accompanying notes.



## CHARLOTTE RUSSE HOLDING, INC.

## CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended	
	December 24, 2005	December 25, 2004
Net sales	\$ 201,454,195	\$ 149,982,125
Cost of goods sold, including buying, distribution and occupancy costs	152,072,586	115,181,777
Gross profit	49,381,609	34,800,348
Selling, general and administrative expenses	37,965,371	31,315,458
Operating income	11,416,238	3,484,890
Other income (expense):		
Interest income, net	352,617	122,662
Other charges, net	(62,506)	(63,199)
Total other income	290,111	59,463
Income before income taxes	11,706,349	3,544,353
Income taxes	4,647,420	1,382,297
Net income	\$ 7,058,929	\$ 2,162,056
Earnings per share:		
Basic	\$ 0.32	\$ 0.10
Diluted	\$ 0.29	\$ 0.09
Weighted average shares outstanding:		
Basic	22,212,200	21,956,593
Diluted	24,468,064	24,012,728

See accompanying notes.

## CHARLOTTE RUSSE HOLDING, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	Three Months Ended	
	December 24, 2005	December 25, 2004
<b>Operating Activities</b>		
Net income	\$ 7,058,929	\$ 2,162,056
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,053,430	7,783,433
Amortization of construction allowances	(3,053,912)	(2,251,471)
Landlord construction allowances	4,215,077	1,399,598
Stock based compensation	620,000	
Deferred rent	208,129	320,565
Loss on disposal of assets	160,058	45,220
Deferred income taxes	(490,000)	300,000
Changes in operating assets and liabilities:		
Inventories	6,341,299	10,657,329
Other current assets	3,053,437	(96,280)
Accounts payable, trade	(7,166,465)	(5,739,809)
Accounts payable, other	1,535,311	(3,627,634)
Accrued payroll and related expense	3,697,201	1,490,328
Income and sales taxes payable	4,081,774	1,664,723
Other current liabilities	6,132,220	4,151,649
Net cash provided by operating activities	35,446,488	18,259,707
<b>Investing Activities</b>		
Purchases of fixed assets	(11,111,343)	(7,196,379)
Other assets	50,994	(12,427)
Net cash used in investing activities	(11,060,349)	(7,208,806)
<b>Financing Activities</b>		
Net proceeds from issuance of common stock	1,609,853	53,399
Excess tax benefits from option exercises	390,000	
Net cash provided by financing activities	1,999,853	53,399
Net increase in cash and cash equivalents	26,385,992	11,104,300
Cash and cash equivalents at beginning of the period	33,693,158	30,713,343
Cash and cash equivalents at end of the period	\$ 60,079,150	\$ 41,817,643

See accompanying notes.





**CHARLOTTE RUSSE HOLDING, INC.**

**Notes to Consolidated Financial Statements (Unaudited)**

**1. Interim Financial Statements**

The accompanying unaudited consolidated financial statements of Charlotte Russe Holding, Inc. (the Company) have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Certain information and footnote disclosures required by accounting principles generally accepted in the United States for complete financial statements have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, the accompanying unaudited financial statements contain all material adjustments, consisting of normal recurring accruals, necessary to present fairly the Company's financial position, results of operations and cash flows for the periods indicated, and have been prepared in a manner consistent with the audited financial statements for the fiscal year ended September 24, 2005.

Due to the seasonal nature of the Company's business, the results of operations for the three month period ended December 24, 2005 are not necessarily indicative of the results of a full fiscal year.

These financial statements should be read in conjunction with the audited financial statements and the footnotes for the fiscal year ended September 24, 2005 included in the Company's Annual Report on Form 10-K, filed with the Securities and Exchange Commission on December 7, 2005.

**2. Stock Based Compensation**

Effective September 25, 2005, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS 123(R)), using the modified prospective application transition method, which establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at the grant date, based on the fair value of the award, over the requisite service period. The Company previously applied Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, as permitted by FASB Statement No. 123, *Accounting for Stock-Based Compensation* (SFAS 123).

Prior to the adoption of SFAS 123(R), the Company provided the disclosures required under SFAS 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The Company did not recognize stock-based compensation expense in its statement of income for periods prior to the adoption of SFAS 123(R).

## CHARLOTTE RUSSE HOLDING, INC.

## Notes to Consolidated Financial Statements (Unaudited) (Continued)

## 2. Stock Based Compensation (continued)

The following table illustrates the effect on net income and net income per share as if the Company had applied the fair value recognition provisions of SFAS 123(R) to options granted under the Company's stock-based compensation plans for the quarter ended December 25, 2004, prior to the adoption of SFAS 123(R). For purposes of this pro forma disclosure, the value of the options was estimated using a Black-Scholes-Merton (BSM) option-pricing formula and amortized on a straight-line basis over the respective vesting periods of the awards. Disclosures for the three months ended December 24, 2005 are not presented in the following table because stock-based payments were accounted for under SFAS 123(R)'s fair-value method during that period.

	<b>Three Months Ended December 25, 2004</b>
Reported net income	\$ 2,162,056
Less: Pro forma stock-based compensation expense determined under the fair value based method, net of tax	(123,173)
Pro forma net income	\$ 2,038,883
Reported net income per share basic	\$ 0.10
Reported net income per share diluted	\$ 0.09
Pro forma net income per share basic	\$ 0.09
Pro forma net income per share diluted	\$ 0.08

## Adoption of SFAS 123(R)

During the quarter ended December 24, 2005, the Company recorded stock-based compensation cost totaling the amount that would have been recognized had the fair value method been applied since the effective date of SFAS 123(R). Results for prior periods have not been restated. The effect of recording stock-based compensation for the three month period ended December 24, 2005 was as follows:

	<b>Three Months Ended December 24, 2005</b>
Stock-based compensation expense by type of award:	
Employee stock options	\$ 600,754
Employee stock purchase plan	19,246
Total stock-based compensation expense	\$ 620,000
Tax effect on stock-based compensation expense	(246,140)

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Net effect on net income	\$	373,860
<hr/>		
Effect on income per share:		
Basic and diluted	\$	(0.02)

As required by SFAS 123(R), management has made an estimate of expected forfeitures and the Company is recognizing compensation costs only for those equity awards expected to vest.

*Stock Options:* During the three months ended December 24, 2005, the Company granted approximately 0.2 million stock options with an estimated total grant-date fair value of \$2.4 million. Of this amount, the Company estimated that the stock-based compensation for the awards not expected to vest was \$0.2 million. The Company recognized share-based compensation expense of \$0.6 million in the three months ended December 24, 2005, of which \$0.2 million was a component of cost of goods sold and \$0.4 million was a component of selling, general and administrative expenses. As of December 24, 2005, there was \$4.3 million of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 2.3 years.

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**CHARLOTTE RUSSE HOLDING, INC.**
**Notes to Consolidated Financial Statements (Unaudited) (Continued)****2. Stock Based Compensation (continued)**

*Employee Stock Purchase Plan (ESPP):* During the three months ended December 24, 2005, the Company recorded stock-based compensation cost related to its employee stock purchase plan of \$19,246.

**Valuation Assumptions**

In connection with the adoption of SFAS 123(R), the Company estimated the fair value of stock options using a BSM valuation model. The fair value of each option grant is estimated on the date of grant using the BSM option valuation model and the straight-line attribution approach with the following weighted-average assumptions:

	<b>Employee Stock Option Plans</b>		<b>Employee Stock Purchase Plan</b>	
	<b>December 24, 2005</b>	<b>December 25, 2004</b>	<b>December 24, 2005</b>	<b>December 25, 2004</b>
Risk free interest rate	4.40%	3.30%	4.40%	3.30%
Dividend yield				
Expected volatility	48.0%	55.0%	48.0%	55.0%
Weighted average expected life	5.0 years	4.0 years	0.5 years	0.5 years

*Risk-Free Interest Rate:* The Company bases the risk-free interest rate used in the BSM valuation method on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term.

*Expected Dividend:* The BSM valuation model calls for a single expected dividend yield as an input. The Company has never paid any dividends.

*Expected Volatility:* The fair value of stock based payments made were valued using the BSM valuation method with a volatility factor based on the Company's historical stock prices and consideration of future events.

*Expected Term:* The Company's expected term represents the period that the Company's stock-based awards are expected to be outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of its stock-based awards.

*Estimated Pre-vesting Forfeitures:* The Company uses historical data to estimate option exercises and employee terminations used in the model.

***Stock Option Activity***

The following is a summary of stock option activities during the three months ended December 24, 2005:

	<b>Options</b>	<b>Weighted Average Exercise Price</b>
Balance as of September 24, 2005	1,961,970	\$ 11.00
Granted	249,500	15.28
Canceled	(33,400)	12.13
Exercised	(384,220)	4.19
	<hr/>	<hr/>
Balance as of December 24, 2005	1,793,850	\$ 13.03
	<hr/>	<hr/>

CHARLOTTE RUSSE HOLDING, INC.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

**2. Stock Based Compensation (continued)**

The total fair value of shares that vested during the three months ended December 24, 2005 was \$0.7 million. The total cash received from employees as a result of employee stock option exercises and employee stock purchase plan purchases during the three months ended December 24, 2005 was approximately \$1.6 million.

*Stock Options*

In 1996, the Company established a Long-Term Incentive Plan (the 1996 Plan). The 1996 Plan provides for the issuance of shares of Common Stock under incentive stock options and non-qualified stock options. Options vest ratably at 20% per year over five years from the date of the grant, subject to certain acceleration provisions and are exercisable for a period of up to ten years from the date of grant. Incentive stock options are granted at prices that approximate the fair value of the Common Stock at the date of grant as determined by the Board of Directors.

In May 1999, the Company established a 1999 Long-Term Incentive Plan (the 1999 Plan). The 1999 Plan provides for the issuance of shares of Common Stock under non-qualified stock options and stock appreciation rights. The exercise price of options shall not be less than 85% of the fair market value at the date of grant, or 110% in the case of any person possessing 10% combined voting power of all classes of stock of the Company. The Company's Board of Directors determines the vesting and other provisions of option and stock appreciation rights granted under the 1999 Plan. In July 1999, the Company's Board of Directors resolved that no further stock option grants will be made from the 1996 Plan or the 1999 Plan.

The Company's Board of Directors and stockholders adopted the 1999 Equity Incentive Plan, effective as of the completion of its initial public offering. The 1999 Equity Incentive Plan permits the grant of options that qualify as incentive stock options and non-qualified stock options. The exercise price of each option shall be determined by the compensation committee of the Board of Directors. In the case of incentive stock options, however, the exercise price shall not be less than 100% of the fair market value of the shares on the date of grant, or 110% in the case of incentive stock options granted to an individual with ownership in excess of certain limits. Subject to adjustment for stock splits and similar events, the total number of shares of Common Stock that can be issued under the 1999 Equity Incentive Plan is 2,250,000 shares. At December 24, 2005, there were 199,400 shares available for issuance. The terms of these options are substantially the same as other options previously issued.

*Stock Purchase Plan*

On September 27, 1999, the Company approved the adoption of the 1999 Employee Stock Purchase Plan (the Plan), which authorized up to 350,000 shares of Common Stock available for employee purchase through payroll deductions at 85% of fair market value. At December 24, 2005, there were 212,678 shares available for purchase. All eligible employees of the Company may participate. Eligibility is defined as those employees who have completed at least six months of employment and work at least 20 hours per week, except for employees who own Common Stock or options on such Common Stock that represents 5% or more of the Company total equity ownership.



## CHARLOTTE RUSSE HOLDING, INC.

## Notes to Consolidated Financial Statements (Unaudited) (Continued)

## 3. Net Income Per Common Share

Basic earnings per share is calculated based on the weighted average outstanding common shares. Diluted earnings per share is calculated based on the weighted average outstanding shares and potentially dilutive stock options and warrants. In accordance with Statement of Financial Accounting Standards No. 128, *Earnings Per Share*, the following table reconciles income and share amounts utilized to calculate basic and diluted net income per common share.

	Three Months Ended	
	December 24, 2005	December 25, 2004
Net income	\$ 7,058,929	\$ 2,162,056
Earnings per share:		
Basic	\$ 0.32	\$ 0.10
Effect of dilutive warrants	(0.02)	(0.01)
Effect of dilutive stock options	(0.01)	
Diluted	\$ 0.29	\$ 0.09
Weighted average number of shares:		
Basic	22,212,200	21,956,593
Effect of dilutive warrants	1,852,315	1,802,459
Effect of dilutive stock options	403,549	253,676
Diluted	24,468,064	24,012,728

The calculation of dilutive shares excludes the effect of the following options that are considered anti-dilutive:

	Three Months Ended	
	December 24, 2005	December 25, 2004
Anti-dilutive options	634,962	558,273



#### 4. Recent Accounting Pronouncements

In October 2005, the FASB issued FASB Staff Position Financial Accounting Standard ( FSP FAS ) 13-1, *Accounting for Rental Costs Incurred during Construction Period*. FSP FAS 13-1 clarifies the accounting for rental costs associated with operating leases that are incurred during a construction period. In addition, FSP FAS 13-1 requires that a lessee shall cease capitalizing rental costs as of the effective date of this FSP FAS 13-1 for operating lease arrangements entered into prior to the effective date of FSP FAS 13-1. FSP FAS 13-1 is effective for periods beginning after December 15, 2005. The Company does not expect the adoption of FSP FAS 13-1 to have a material impact on the Company's operating results or financial condition.

#### 5. Commitments and Contingencies

On December 14, 2004, plaintiff David Phillips, on behalf of himself and purportedly on behalf of a class of others similarly situated, filed a complaint seeking damages in the United States District Court for the Southern District of California against the Company and two of the Company's officers, alleging violations of federal securities laws related to declines in the Company's stock price in connection with various statements and

**CHARLOTTE RUSSE HOLDING, INC.**

**Notes to Consolidated Financial Statements (Unaudited) (Continued)**

**5. Commitments and Contingencies (*continued*)**

alleged omissions to the public and to the securities markets. Two follow-on actions were filed in the same court alleging substantially similar claims, and on April 25, 2005, all these claims were consolidated into a single action. On October 31, 2005, the Company reached an agreement in principle (subject to court approval) to settle the securities litigation pending against the Company and certain of the Company's officers and directors for the sum of \$3.9 million, paid mostly by the Company's insurance carrier. In the fourth quarter of fiscal 2005, the Company incurred a pre-tax charge of approximately \$600,000 associated with defense and settlement costs.

In addition to the foregoing, from time to time, the Company may be involved in litigation relating to claims arising out of its operations. As of the date of this filing, the Company is not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****FORWARD-LOOKING STATEMENTS**

We have made statements in this Quarterly Report on Form 10-Q that are forward-looking statements. You can identify these statements by forward-looking words such as may, will, expect, intend, anticipate, believe, estimate and continue or similar words. These forward-looking statements may also use different phrases. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements, which are subject to risks, uncertainties, and assumptions about us, may include, among other things, projections of our future results of operations or of our financial condition, and statements about our anticipated growth strategies.

There may be events in the future that we are not able to accurately predict or which we do not fully control that could cause actual results to differ materially from those expressed or implied in our forward-looking statements. Because these forward-looking statements involve risks and uncertainties, there are important factors that could cause actual results to differ materially from those expressed or implied by these forward-looking statements, including shopping mall traffic and shopping patterns, timing of openings for new shopping malls or our stores, fashion trends, national or regional economic influences, weather, consumer demands and preferences, competition from other retailers and uncertainties generally associated with women's apparel and accessory retailing, and other factors discussed in our Annual Report on Form 10-K, filed with the Securities and Exchange Commission on December 7, 2005.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

**RESULTS OF OPERATIONS**

Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with our Consolidated Financial Statements and Notes thereto included elsewhere in this Quarterly Report on Form 10-Q. The following table sets forth our operating results, expressed as a percentage of net sales, and store numbers for the periods indicated. These operating results are not necessarily indicative of the results that may be expected for any future period.

	<b>Three Months Ended</b>	
	<b>December 24, 2005</b>	<b>December 25, 2004</b>
Net sales	100.0%	100.0%
Cost of goods sold	75.5	76.8
Gross profit	24.5	23.2
Selling, general and administrative expenses	18.8	20.9
Operating income	5.7	2.3
Interest income, net	0.1	0.1
Other charges, net	(0.0)	(0.0)
Income before income taxes	5.8	2.4

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Income taxes	2.3	1.0
Net income	3.5%	1.4%
Number of stores open at end of period	422	368

**Three Months Ended December 24, 2005 Compared to the Three Months Ended December 25, 2004**

*Net Sales.* Our net sales increased to \$201.5 million from \$150.0 million, an increase of \$51.5 million, or 34.3%, over the same quarter last year. This increase reflects \$29.5 million of additional net sales from the 14 new stores opened during the three months ended December 24, 2005 as well as other stores opened in prior fiscal periods that did not qualify as comparable stores, and a 15.6% increase in comparable store sales, which resulted in increased sales of \$21.9 million compared to the same quarter in the prior fiscal year.

*Gross Profit.* Gross profit represents net sales less cost of goods sold, which includes buying, distribution and occupancy costs. Our gross profit increased to \$49.4 million from \$34.8 million, an increase of \$14.6 million, or 41.9%, from the same quarter last year. This increase was primarily the result of increased sales and higher gross profit margins. As a percentage of net sales, gross profit increased to 24.5% from 23.2%. The increase in gross profit as a percentage of net sales was principally due to a decrease in store occupancy costs, partially offset by an increase in markdowns.

*Selling, General and Administrative Expenses.* Our selling, general and administrative expenses increased to \$38.0 million from \$31.3 million, an increase of \$6.7 million, or 21.2%, over the same quarter last year. This increase was attributable to new store expansion and increased corporate expenses, specifically stock option and bonus expenses, professional fees and other operating expenses. As a percentage of net sales, selling, general and administrative expenses decreased to 18.8% from 20.9%, primarily due to decreased store operating expenses, partially offset by increased corporate expense primarily consisting of stock-based compensation expense.

*Income Taxes.* Our effective tax rate of 39.7% approximates our statutory income tax rate and is similar to the 39.0% tax rate utilized during the same quarter last year.

*Net Income.* Our net income was approximately \$7.1 million compared to net income of approximately \$2.2 million for the same quarter last year. This increase was primarily due to increased sales and gross profit, offset by increased selling, general and administrative expenses and increased income tax expense.

## **LIQUIDITY AND CAPITAL RESOURCES**

Our working capital requirements vary consistent with the seasonality of our business. Our capital requirements result primarily from capital expenditures related to new store openings. We have historically satisfied our cash requirements principally through cash flow from operations, although in some prior years we have also used borrowings under prior credit facilities for acquisitions, including our acquisition and the acquisition of the Rampage stores. Due to the rapid turnover of our inventory, we generate trade payables and other accrued liabilities sufficient to offset most of our working capital requirements, and this allows us to generally operate with limited working capital. As of December 24, 2005, we had working capital of approximately \$60.7 million which included cash and cash equivalents of \$60.1 million.

Our net cash provided by operations was \$35.4 million and \$18.3 million for the three months ended December 24, 2005 and December 25, 2004, respectively. The increase was primarily due to higher net income, increased investment in working capital accounts and a higher non-cash adjustment for depreciation, amortization and stock option expense. Our net cash used in investing activities was \$11.1 million and \$7.2 million for the three months ended December 24, 2005 and December 25, 2004, respectively. The primary component of investing activities during both quarters was purchases of fixed assets, which consisted primarily of new store openings and other corporate expenditures.

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In the three months ended December 24, 2005 and December 25, 2004, we opened 14 and 8 new stores, respectively. During fiscal 2006, we plan to open up to 35 new Charlotte Russe stores. After taking into account new store construction, existing store remodeling, distribution center expenditures, and other corporate capital projects, total capital expenditures for fiscal year 2006 are projected to range from approximately \$38.0 to \$42.0 million, of which \$11.1 million was spent during the three months ended December 24, 2005.

Our net cash provided by financing activities was \$2.0 and \$0.1 million for the three months ended December 24, 2005 and December 25, 2004, respectively. Net cash from financing activities primarily consists of the net proceeds of stock option exercises.

We currently have a \$40.0 million secured revolving credit facility (the "Credit Facility") with Bank of America, N.A., which expires on June 30, 2010. Under the terms of the Credit Facility, we may borrow up to the maximum borrowing limit of \$40.0 million less any outstanding letters of credit, and we have set the initial loan ceiling amount at \$30.0 million. Interest on the Credit Facility is payable quarterly, at our option, at either (i) the Bank's prime rate plus 0.50% to 1.00% ("Base Rate"), or (ii) 1.00% to 1.50% over the average interest settlement rate for deposits in the London interbank market banks ("Eurodollar Rate") subject to certain adjustments. Our ability to receive loan advances under the Credit Facility is subject to our continued compliance with various covenants, representations and warranties, and conditions, including but not limited to negative covenants against the incurrence of debt or liens. The Credit Facility also contains events of default customary for facilities of this type and provides that, upon the occurrence of an event of default, payment of all outstanding loans may be accelerated and/or the lenders' commitments may be terminated. Pursuant to this agreement, we and our wholly-owned subsidiaries have (i) provided an unconditional guarantee of the full and punctual payment of obligations under the Credit Facility, (ii) pledged certain of our securities to the collateral agent as security for the full payment and performance of our obligations under the Credit Facility and (iii) granted a security interest in essentially all of our personal property as security for the full payment and performance of our obligations under the Credit Facility. At December 24, 2005, there was no outstanding debt under the Credit Facility and we were in compliance with the terms of the bank credit agreement. As of December 24, 2005, we currently have \$23.1 million of borrowing availability under the Credit Facility.

We believe that our cash flows from operations, our current cash balance and the funds available under our Credit Facility will be sufficient to meet our working capital needs and contemplated capital expenditure requirements through fiscal 2006. If our cash flow from operations should decline significantly, it may be necessary for us to seek additional sources of capital to reduce planned new store openings.

## LETTERS OF CREDIT

Pursuant to the terms of the Credit Facility, we can issue up to \$20.0 million of documentary or standby letters of credit. The outstanding commitments under the Credit Facility at December 24, 2005 totaled approximately \$6.9 million, including \$2.2 million in standby letters of credit.

## CONTRACTUAL OBLIGATIONS

Our commitment to make future payments under long-term contractual obligations was as follows, as of December 24, 2005:

	Total	Less Than 1 Year	1-3 Years	3-5 Years	After 5 Years
(dollars in thousands)					
<b>Contractual Obligations:</b>					
Operating leases	\$ 516,180	\$ 73,972	\$ 145,323	\$ 135,657	\$ 161,228
Other long-term obligations	5,250	750	1,500	1,500	1,500
	<u>\$ 521,430</u>	<u>\$ 74,722</u>	<u>\$ 146,823</u>	<u>\$ 137,157</u>	<u>\$ 162,728</u>





## CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's Discussion and Analysis of Financial Condition and Results of Operations discusses our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements, as well as revenues and expenses during the reported periods.

On an on-going basis, management evaluates its estimates and judgments regarding inventories, receivables, fixed assets, intangible assets, accrued liabilities, income taxes and contingencies and litigation. Management bases its estimates and judgments on historical experience and on various other factors that are believed to be reasonable under the circumstances. The results from this evaluation form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Under different assumptions or conditions, alternative estimates and judgments could be derived which would differ from the estimates being used by management. Actual results could differ from any or all of these estimates.

As a retailer of women's apparel and accessories, our financial statements are affected by several critical accounting policies, many of which affect management's use of estimates and judgments, as described in the Notes to our Consolidated Financial Statements included elsewhere in this Quarterly Report on Form 10-Q. We sell merchandise directly to retail customers and recognize revenue at the point of sale. Customers have the right to return merchandise to us, and we maintain a reserve for the financial impact of returns which occur subsequent to the current reporting period.

We estimate the fair value of stock options granted using the Black-Scholes-Merton option-pricing formula and a multiple option award approach. This fair value is then amortized over the requisite service periods of the awards. This option-pricing model requires the input of highly subjective assumptions, including the option's expected life, price volatility of the underlying stock, risk free interest rate and expected dividend rate. As stock-based compensation expense is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based on historical experience.

Our policy with respect to gift cards is to record revenue as the gift cards are redeemed for merchandise. Prior to their redemption, unredeemed gift cards are recorded as a liability, included within accrued expenses and other current liabilities. Revenue recognized from gift card forfeitures is based upon an expected forfeiture rate determined from historical trends and for each period presented has had an immaterial financial statement impact.

Our merchandise is initially offered for sale at a regular price, but is often marked down prior to the ultimate sale of all such units. We utilize the retail method of accounting for our inventory valuation that inherently reduces the inventories' carrying value as permanent markdowns are initiated. In addition, we maintain a reserve for the financial impact of markdowns that we believe are likely to be encountered in the future. If actual demand or market conditions are more or less favorable than those projected by management, the level of the reserve for future markdowns would be subject to change in subsequent reporting periods.

We also provide for estimated inventory losses for damaged, lost or stolen inventory for the period from the last physical inventory to the financial statement date. These estimates are based on historical experience and other factors.

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We receive certain allowances from our vendors primarily related to distribution center handling expenses or defective merchandise. These allowances are reflected as a reduction of merchandise inventory in the period they are received and allocated to cost of sales during the period in which the items were sold.

We have recorded a goodwill asset that arose from the acquisition of our business in September 1996. This asset is tested for possible impairment on at least an annual basis in accordance with SFAS No. 142, *Goodwill and Other Intangibles*. The carrying value of investments in our stores, principally leasehold improvements and equipment, and other operations is reviewed for impairment on at least an annual basis in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. In prior years, we established reserves for stores which have been closed, and no other stores are contemplated for closure at this time.

We record rent expense on noncancellable leases containing known future scheduled rent increases on a straight-line basis over the respective leases beginning when we receive possession of the leased property for construction purposes. The difference between rent expense and rent paid is accounted for as deferred rent. Landlord construction allowances and other such lease incentives are recorded as deferred lease credits, and are amortized on a straight-line basis as a reduction to rent expense.

### RECENT ACCOUNTING PRONOUNCEMENTS

In October 2005, the FASB issued FASB Staff Position Financial Accounting Standard ( FSP FAS ) 13-1, *Accounting for Rental Costs Incurred during Construction Period*. FSP FAS 13-1 clarifies the accounting for rental costs associated with operating leases that are incurred during a construction period. In addition, FSP FAS 13-1 requires that a lessee shall cease capitalizing rental costs as of the effective date of FSP FAS 13-1 for operating lease arrangements entered into prior to the effective date of FSP FAS 13-1. FSP FAS 13-1 is effective for periods beginning after December 15, 2005. We do not expect the adoption of FSP FAS 13-1 to have a material impact on our operating results or financial condition.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our market risks relate primarily to changes in interest rates. We bear this risk in two specific ways. First, the Credit Facility carries a variable interest rate that is tied to market indices and, therefore, our statement of income and our cash flows are exposed to changes in interest rates. As of December 24, 2005, we had no borrowings against our Credit Facility. However, we may borrow additional funds under our Credit Facility as needed.

The second component of interest rate risk involves the short-term investment of excess cash in short-term, investment-grade interest-bearing securities. These investments are considered to be cash equivalents and are shown that way on our balance sheet. If there are changes in interest rates, those changes would affect the investment income we earn on these investments and, therefore, impact our cash flows and results of operations.

We believe our market risk exposure is immaterial.

### ITEM 4. CONTROLS AND PROCEDURES

Based upon an evaluation, under the supervision and with the participation of our Disclosure Committee and management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Securities Exchange Act of 1934 Rules 13a-15(b) and 15d-15(b), the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the three month period ended December 24, 2005, our disclosure controls and procedures are effective.

**Changes in Internal Control Over Financial Reporting**

There were no changes in our internal controls during the fiscal quarter ended December 24, 2005 that materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **PART II OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

On December 14, 2004, plaintiff David Phillips, on behalf of himself and purportedly on behalf of a class of others similarly situated, filed a complaint seeking damages in the United States District Court for the Southern District of California against us and two of our officers, alleging violations of federal securities laws related to declines in our stock price in connection with various statements and alleged omissions to the public and to the securities markets. Two follow-on actions were filed in the same court alleging substantially similar claims, and on April 25, 2005, all these claims were consolidated into a single action. On October 31, 2005, we reached an agreement in principle (subject to court approval) to settle the securities litigation pending against us and certain of our officers and directors for the sum of \$3.9 million, paid mostly by our insurance carrier. In the fourth quarter of fiscal 2005, we incurred a pre-tax charge of approximately \$600,000 associated with defense and settlement costs.

In addition to the foregoing, from time to time, we may be involved in litigation relating to claims arising out of our operations. As of the date of this filing, we are not engaged in any legal proceedings that are expected, individually or in the aggregate, to have a material adverse effect on our business, financial condition or results of operations.

### **ITEM 1A. RISK FACTORS**

#### **RISKS RELATING TO OUR BUSINESS**

*Our success depends on our ability to identify and rapidly respond to consumer fashion tastes.*

The apparel industry is subject to rapidly evolving fashion trends and shifting consumer demands. Accordingly, our success is heavily dependent both on the priority our target customers place on fashion and on our ability to anticipate, identify and capitalize upon emerging fashion trends in a timely manner. Current fashion tastes place significant emphasis on a fashionable look. In the past this emphasis has increased and decreased through fashion cycles and decreased emphasis has adversely affected our results. If we do not anticipate, identify or react appropriately and timely to changes in styles, trends, desired images or brand preferences, it may lead to, among other things, excess inventories and higher markdowns, as well as decreased appeal of our brands.

*We intend to continue to open new stores, which could strain our resources and cause us to operate our business less effectively.*

Our growth will largely depend on successfully opening and operating new stores. During fiscal 2005, we opened 49 new stores and closed 1 Rampage store representing a 13% net increase from the number of stores open at the end of fiscal 2004. During the three months ended December 24, 2005, we opened 14 new stores and we plan to open up to 35 new Charlotte Russe stores during fiscal 2006, an increase of 9% from total stores opened as of September 24, 2005. We intend to continue to increase our number of stores for at least the next several years.

In order to support our planned expansion we will need to continually monitor and upgrade our management information and other systems. This expansion also will place increased demand on our managerial, operational, and administrative resources. These increased demands and operating complexities could cause us to operate our business less effectively, which in turn could cause deterioration in the financial

performance of our individual stores and slow our new store growth.

*Our planned expansion involves a number of risks that could prevent or delay the successful opening of new stores as well as impact the performance of our existing stores.*

Our ability to open and operate new stores successfully depends on many factors, including, among others, our ability to:

identify suitable store locations, the availability of which is outside of our control;

negotiate acceptable lease terms, including desired tenant improvement allowances;

source sufficient levels of inventory to meet the needs of new stores;

hire, train and retain store personnel;

successfully integrate new stores into our existing operations; and

identify and satisfy the fashion preferences of new geographic areas.

In addition, some of our new stores will be opened in regions of the United States in which we currently have few or no stores. The expansion into new markets may present competitive, merchandising and distribution challenges that are different from those currently encountered in our existing markets. Any of these challenges could adversely affect our business and results of operations. In addition, to the extent our new store openings are in existing markets, we may experience reduced net sales volumes in existing stores in those markets.

*A decline in general economic conditions may lead to reduced consumer demand for our apparel and accessories.*

Consumer spending habits, including spending for the fashionable apparel and related accessories that we sell, are affected by, among other things, prevailing economic conditions, levels of employment, salaries and wage rates, consumer confidence and consumer perception of economic conditions. A general slowdown in the United States economy and an uncertain economic outlook could adversely affect consumer spending habits and mall traffic, which could result in lower net sales than expected and could cause us to slow our expansion plans.

*Our stores are heavily dependent on the customer traffic generated by shopping malls.*

Most of our store locations are not sufficiently concentrated to make significant marketing expenditures cost effective. As a result, we depend heavily on locating our stores in prominent locations within successful shopping malls in order to generate customer traffic. We cannot control the development of new shopping malls, the availability or cost of appropriate locations within existing or new shopping malls or the success of individual shopping malls.

*Our market share may be adversely impacted at any time by a significant number of competitors.*

We operate in a highly competitive environment characterized by low barriers to entry. We compete against a diverse group of retailers, including national and local specialty retail stores, regional retail chains, traditional department stores and, to a lesser extent, mass merchandisers. Our market share and results of operations may be adversely impacted by this significant number of competitors. Many of our competitors also are larger and have substantially greater resources than we do.

*We rely on our good relationships with vendors to implement our business strategy successfully.*

Our business is dependent on continued good relations with our vendors. In particular, we believe that we generally are able to obtain attractive pricing and other terms from vendors because we are perceived as a desirable customer. Our test-and-reorder merchandise strategy also relies in large part on our ability to obtain much of our merchandise from our vendors within three to six weeks from the date of order. Our failure to



maintain good relations with our vendors could increase our exposure to changing fashion cycles, which may in turn lead to increased inventory markdown rates.

*Certain members of our senior management team have limited tenure with us.*

Our business requires disciplined execution at all levels of our organization in order to timely deliver and display fashionable merchandise in appropriate quantities in our stores. This execution requires experienced and talented management. If we fail to attract, motivate and retain qualified and talented key personnel, it may adversely affect our business and inhibit our plans for future growth.

During fiscal 2005, we hired a new Senior Vice President of Apparel for Charlotte Russe and a Vice President of Stores. Each of these individuals has significant experience in these and similar roles with other apparel retailers, although they have limited tenure with our company.

*If at any time our comparable store sales and quarterly results of operations decline or do not meet the expectations of research analysts, the price of our common stock could decline substantially.*

Our quarterly results of operations for our individual stores have fluctuated in the past and can be expected to continue to fluctuate in the future. For instance, our quarterly comparable store sales percentages have ranged as high as positive 15.6% and as low as negative 9.9% over the past two years. Our net sales and operating results are typically lower in the second quarter of our fiscal year due to the traditional retail slowdown immediately following the winter holiday season. Our comparable store sales and quarterly results of operations are affected by a variety of factors, including:

the timing of new store openings and the relative proportion of new stores to mature stores;

efforts to reposition the targeted customer for our Rampage stores;

fashion trends;

calendar shifts of holiday or seasonal periods;

the effectiveness of our test-and-reorder strategy in maintaining appropriate inventory levels;

changes in our merchandise mix;

timing of promotional events;

general economic conditions and, in particular, the retail sales environment;

actions by competitors or mall anchor tenants;

weather conditions; and

the level of pre-opening expenses associated with new stores.

***Our business and reputation may be adversely affected if our Rampage stores are associated with negative publicity related to the use of the Rampage trademark by other parties.***

In connection with the acquisition of our Rampage stores, we acquired the exclusive right within the United States to use the Rampage trademark on exterior and interior signage identifying our Rampage stores, as well as the non-exclusive right within the United States to use the Rampage trademark for promotional and advertising materials. We do not, however, have the right to use the Rampage trademark on our merchandise. The right to market merchandise under the Rampage trademark was retained by Rampage Clothing Company. Further, nothing in our license agreement with Rampage Clothing Company prohibits the sale of merchandise bearing the Rampage trademark by other parties or the licensing of the Rampage trademark to other parties. In fact, Rampage Clothing Company has licensed the trademark to other parties. We believe a positive Rampage brand image is important to our success. Accordingly, if the merchandise sold by the Rampage Clothing Company or other

parties under the Rampage trademark is of low quality or if the Rampage Clothing Company or these parties otherwise engage in activities that negatively affect the Rampage trademark or are otherwise inconsistent with our Rampage store concept, consumers could lose confidence in our merchandise and our reputation and business could be materially adversely affected.

***The failure to efficiently complete the planned replacement of certain of our technology and information systems could negatively impact our business.***

The efficient operation of our business is heavily dependent on information systems. In particular, we rely upon technology and information systems for inventory control and other critical information. We periodically review, improve and, under certain circumstances, replace information systems to provide enhanced support to all operating areas. If such upgrades and enhancements are not successfully implemented, then the current systems may not be able to continue to adequately support our information requirements. We have recently initiated the replacement of our existing inventory software systems. If we are unable to complete this conversion in an efficient and timely manner, our business could be negatively impacted.

***Our operations, as well as a substantial number of our stores, are concentrated in the Southwest and other heavily populated regional areas, which makes us susceptible to adverse conditions in these regions.***

Our headquarters and distribution centers are located in California, and a substantial number of our stores are located in California, Florida and Texas. As a result, our business may be more susceptible to regional factors than the operations of more geographically diversified competitors. These factors include, among others, economic and weather conditions, demographic and population changes, and fashion tastes. Further, a natural disaster or other catastrophic event, such as an earthquake affecting southern California, or hurricanes affecting the Southeastern states and Texas, could significantly disrupt our operations.

***The loss of, or disruption of operations in, either of our two distribution centers could negatively impact our business.***

Our merchandise is distributed through two modern facilities that use automated systems for sorting apparel and shipping merchandise. We depend on the orderly operation of our facilities and distribution processes, as well as sufficient shipping resources. Disruptions in these operations due to fire, earthquake or other catastrophic events, employee matters (including work stoppages), shipping problems or other events could result in delays in the delivery of merchandise to our stores.

***Our business could be adversely impacted by unfavorable international conditions.***

We receive apparel and other merchandise from foreign sources, both purchased directly in foreign markets and indirectly through domestic vendors with foreign sources. To the extent that any of our vendors are located overseas or rely on overseas sources for a large portion of their products, any event causing a disruption of imports, including the imposition of import restrictions, could harm our ability to source product. This disruption could materially limit the merchandise that we would have available for sale and reduce our revenues and earnings. The flow of merchandise from our vendors could also be adversely affected by financial or political instability, or war, in or affecting any of the countries in which the goods we purchase are manufactured or through which they flow. Trade restrictions in the form of tariffs or quotas, or both, that are applicable to the products that we sell also could affect the import of those products and could increase the cost and reduce the supply of products available to us. Any material increase in tariff levels, or any material decrease in quota levels or available quota allocation, could negatively impact our business. Further, changes in tariffs or quotas for merchandise imported from individual foreign countries could lead us to shift our sources of supply among various countries. Any such shift we undertake in the future could result in a disruption of our sources of

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supply and lead to a reduction in our revenues and earnings. Supply chain security initiatives undertaken by the U.S. government that impede the normal flow of product could also negatively impact our business.

*The effects of war or acts of terrorism could adversely affect our business.*

The continued threat of terrorism, heightened security measures and military action in response to an act of terrorism has disrupted commerce and has intensified the uncertainty of the United States economy. Any further acts of terrorism, particularly directed at malls, or new or extended hostilities may disrupt commerce and undermine consumer confidence, which could negatively impact our sales by causing mall traffic or consumer spending to decline.

## **ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

### **Dividends**

We have never declared nor paid dividends on our common stock and we do not intend to pay any dividends on our common stock in the foreseeable future. We currently intend to retain earnings to finance future operations and expansion. Moreover, under the terms of the Credit Facility, stock dividends and distributions are restricted.

## **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

## **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

## **ITEM 5. OTHER INFORMATION**

Not applicable.

## **ITEM 6. 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



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the Registrant has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Diego, State of California, on the 20<sup>th</sup> day of January, 2006.

CHARLOTTE RUSSE HOLDING, INC.

By:                     /s/ DANIEL T. CARTER                    

**Daniel T. Carter**

**Executive Vice President and**

**Chief Financial Officer**