

GOTTSCHALKS INC  
Form 10-Q  
June 10, 2005

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

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**FORM 10-Q**

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*(Mark One)*

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

For the quarterly period ended April 30, 2005

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-09100

Gottschalks Inc.

(Exact name of Registrant as specified in its Charter)

**Delaware**

(State or Other Jurisdiction of Incorporation or Organization)

**77-0159791**

(I.R.S. Employer Identification Number)

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7 River Park Place East  
Fresno, California 93720

(Address of Principal Executive Offices including Zip Code)

(559) 434-4800

(Registrant's Telephone Number, Including Area Code)

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

x NO o

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

o NO x

The number of shares of the Registrant's common stock outstanding as of April 30, 2005 was 13,156,833.

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GOTTSCHALKS INC. AND SUBSIDIARY  
INDEX

	<b><u>Page</u></b> <b><u>No.</u></b>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. Financial Statements (Unaudited):	
Condensed balance sheets -	
April 30, 2005, January 29, 2005 and May 1, 2004 (restated)	<u>3</u>
	<u>4</u>

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Condensed statements of operations - thirteen weeks ended April 30, 2005 and May 1, 2004 (restated)	
Condensed statements of cash flows - thirteen weeks ended April 30, 2005 and May 1, 2004 (restated)	<u>5</u>
Notes to condensed financial statements - thirteen weeks ended April 30, 2005 and May 1, 2004	<u>6 - 12</u>
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	<u>13 - 20</u>
Item 3. Quantitative and Qualitative Disclosures About Market Risk	<u>21</u>
Item 4. Controls and Procedures	<u>21</u>
<b>PART II. OTHER INFORMATION</b>	
Item 2. Changes in Securities, Use of Proceeds and Issuer Purchase of Equity Securities	<u>22</u>
Item 6. Exhibits	<u>22</u>
<b>Signatures</b>	<u>23</u>

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PART I -- FINANCIAL INFORMATION

Item 1. Financial Statements
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GOTTSCHALKS INC.  
 CONDENSED BALANCE SHEETS (UNAUDITED - Note 1)  
 (In thousands of dollars)

	April 30, 2005	January 29, 2005	May 1, 2004
			(As Restated) (See Note 8)
<b>ASSETS</b>			
CURRENT ASSETS:			
Cash.....	\$ 5,622	\$ 5,470	\$ 5,893
Receivables, net.....	3,110	6,920	4,419
Merchandise inventories.....	178,104	152,753	184,959
Other.....	10,279	9,669	11,270
Total current assets.....	197,115	174,812	206,541
PROPERTY AND EQUIPMENT - NET.....	127,071	126,509	125,237
GOODWILL - NET.....	7,501	7,501	7,501
OTHER INTANGIBLES - NET.....	643	652	680
OTHER LONG-TERM ASSETS.....	5,133	6,101	6,535
	\$ 337,463	\$ 315,575	\$ 346,494
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
CURRENT LIABILITIES:			
Trade accounts payable and other current liabilities.....	\$ 83,673	\$ 77,131	\$ 84,022
Revolving line of credit.....	--	--	76,880
Current portion of long-term obligations.....	3,243	3,242	2,590
Total current liabilities.....	86,916	80,373	163,492
REVOLVING LINE OF CREDIT.....	63,730	45,753	--
LONG-TERM OBLIGATIONS (less current portion).....	24,898	25,650	28,293
DEFERRED INCOME TAXES AND OTHER LIABILITIES.....	30,698	30,263	28,382
SUBORDINATED NOTE PAYABLE TO AFFILIATE.....	20,180	21,180	22,180
COMMITMENTS AND CONTINGENCIES			
STOCKHOLDERS' EQUITY.....	111,041	112,356	104,147
	\$ 337,463	\$ 315,575	\$ 346,494

See notes to condensed financial statements.



## GOTTSCHALKS INC.

## CONDENSED STATEMENTS OF OPERATIONS (UNAUDITED - Note 1)

(In thousands of dollars, except per share data)

	Thirteen Weeks Ended	
	April 30, 2005	May 1, 2004
		(As Restated) (See Note 8)
Net sales.....	\$ 144,104	\$ 144,533
Net credit revenues.....	779	839
Net leased department revenues.....	744	752
	-----	-----
Total revenues.....	145,627	146,124
Costs and expenses:		
Cost of sales.....	95,233	94,819
Selling, general and administrative expenses.....	48,715	49,110
Depreciation and amortization.....	3,197	3,417
New store opening costs.....	107	
	-----	-----
Total costs and expenses.....	147,252	147,346
	-----	-----
Operating loss.....	(1,625)	(1,222)
Other (income) expense:		
Interest expense.....	1,929	2,874
Miscellaneous income.....	(353)	(462)
	-----	-----
	1,576	2,412
	-----	-----
Loss before income tax benefit.....	(3,201)	(3,634)
Income tax benefit.....	(1,216)	(1,418)
	-----	-----
Loss from continuing operations.....	(1,985)	(2,216)
Discontinued operations:		
Loss on store closures.....	--	(31)
Income tax benefit.....	--	(11)
	-----	-----
Loss on discontinued operations.....	--	(20)
	-----	-----
Net loss.....	\$ (1,985)	\$ (2,236)
	=====	=====
Loss per common share - basic and diluted		
Loss from continuing operations.....	\$ (0.15)	\$ (0.17)
Loss from discontinued operations.....	\$ 0.00	\$ 0.00
Loss per common share.....	\$ (0.15)	\$ (0.17)

Weighted average number of common  
shares outstanding -

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Basic and Diluted.....	13,077	12,883
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See notes to condensed financial statements.

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GOTTSCHALKS INC.  
 CONDENSED STATEMENTS OF CASH FLOWS (UNAUDITED - Note 1)  
 (In thousands of dollars)

	Thirteen Weeks Ended	
	April 30, 2005	May 1, 2004
		(As Restated) (See Note 8)
OPERATING ACTIVITIES:		
Net loss.....	\$ (1,985)	\$ (2,236)
Adjustments:		
Depreciation and amortization.....	3,197	3,417
Other adjustments, net.....	410	(812)
Changes in operating assets and liabilities:		
Receivables.....	3,810	4,726
Merchandise inventories.....	(24,986)	(28,000)
Other current and long-term assets.....	340	(1,137)
Trade accounts payable and accrued expenses.....	5,794	9,541
Other current and long-term liabilities.....	(2,646)	73
Net cash used in operating activities.....	(16,066)	(14,428)
INVESTING ACTIVITIES:		
Capital expenditures.....	(4,164)	(1,495)
Other.....	91	91
Net cash used in investing activities.....	(4,073)	(1,404)
FINANCING ACTIVITIES:		
Net proceeds under revolving line of credit.....	17,977	16,871
Proceeds from long-term obligations.....	--	9,000
Debt issuance costs.....	--	(1,060)
Principal payments on long-term obligations.....	(1,751)	(14,145)
Proceeds from Exercise of Stock Options.....	670	
Changes in cash management liability and other.....	3,395	5,868
Net cash provided by financing activities.....	20,291	16,534
INCREASE IN CASH.....	152	702
CASH AT BEGINNING OF PERIOD.....	5,470	5,172
CASH AT END OF PERIOD.....	\$ 5,622	\$ 5,874
SUPPLEMENTAL INFORMATION:		
Interest paid, net of capitalized interest.....	\$ 2,199	\$ 2,593
Income taxes paid.....	\$ 1,310	\$ 201

See notes to condensed financial statements.





GOTTSCHALKS INC. AND SUBSIDIARY  
 NOTES TO CONDENSED FINANCIAL STATEMENTS (UNAUDITED)  
 Thirteen Weeks Ended April 30, 2005 and May 1, 2004

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1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Gottschalks Inc. (the "Company") is a regional department store chain based in Fresno, California. As of the end of the first quarter of the fiscal year ending January 28, 2006 ("fiscal 2005"), the Company operated 63 full-line Gottschalks department stores located in 6 Western states, with 38 stores in California, 12 in Washington, 6 in Alaska, 3 in Oregon, and 2 in each of Nevada and Idaho. The Company also operates 6 specialty apparel stores, which carry a limited selection of merchandise. The Company's department stores typically offer a wide range of better to moderate brand-name and private-label merchandise for the entire family, including men's, women's, junior's and children's apparel; cosmetics, shoes, fine jewelry and accessories; and home furnishings, including china, housewares, domestics, small electric appliances and furniture (in selected locations). The majority of the Company's department stores range from 40,000 to 150,000 gross square feet, and are generally anchor tenants of regional shopping malls or strategically located strip centers. The Company operates in one reportable operating segment.

The accompanying unaudited condensed financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting primarily of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the thirteen week period ended April 30, 2005 are not necessarily indicative of the results that may be expected for fiscal 2005 due to the seasonal nature of the Company's business. These financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended January 29, 2005 (the "2004 Annual Report on Form 10-K"). The condensed balance sheet at January 29, 2005 has been derived from the audited financial statements as of that date.

2. STOCK-BASED COMPENSATION

At April 30, 2005, the Company has two stock-based employee compensation plans. The Company accounts for those plans under the recognition and measurement principles of Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations. No stock-based employee compensation cost is reflected in net loss, as all options granted under those plans had an exercise price equal to the market value of the underlying common stock on the date of the grant.

The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," to stock-based employee compensation. The Company's calculations were made using the Black-Scholes option pricing model.

	Thirteen Weeks Ended	
	-----	
	April 30,	May 1,
	2005	2004
(In thousands of dollars, except per share data)		

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Net loss as reported.....	\$	(1,985)	\$	(2,236)
Deduct: Total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects.....		(84)		(38)
Pro forma net loss .....	\$	(2,069)	\$	(2,274)
Net loss per share (basic and diluted):				
As reported .....	\$	(0.15)	\$	(0.17)
Pro-forma .....	\$	(0.16)	\$	(0.18)

### 3. MERCHANDISE INVENTORIES

Inventories, which consist of merchandise held for resale, are valued by the retail method and are stated at last-in, first-out (LIFO) cost, which is not in excess of market value. The Company includes in inventory the capitalization of certain indirect costs related to the purchasing, handling and storage of merchandise. Current cost, which approximates replacement cost, under the first-in, first-out (FIFO) method was equal to the LIFO value of inventories at January 29, 2005. A valuation of inventory under the LIFO method is presently made only at the end of each year based on actual inventory levels and costs at that time. Since these factors are subject to variability beyond the control of management, interim results of operations are subject to the final year-end LIFO inventory valuation adjustment. Management does not currently anticipate that its year-end LIFO adjustment will materially affect the Company's fiscal 2005 operating results.

### 4. TRADE ACCOUNTS PAYABLE AND OTHER CURRENT LIABILITIES

Trade accounts payable and other current liabilities consist of the following:

(In thousands of dollars)	April 30, 2005	January 29, 2005	May 1, 2004
Trade accounts payable.....	\$ 38,501	\$ 24,547	\$ 36,209
Accrued expenses.....	19,758	23,385	17,426
Cash management liability.....	8,879	5,483	13,194
Accrued payroll and related liabilities.....	6,778	8,139	7,744
Taxes, other than income taxes.....	7,524	12,059	7,673
Federal and state income taxes payable.....	516	1,801	703
Deferred income taxes payable.....	1,717	1,717	1,073
	\$ 83,673	\$ 77,131	\$ 84,022

### 5. DEBT

#### Senior Revolving Credit Facility

On February 1, 2002, the Company entered into a three-year senior revolving credit facility with General Electric Capital Corporation ("GE Capital") as agent and lender, along with three other lenders (the "Original GE facility"). On March 1, 2004, the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). The GE facility provides up to \$165.0 million of working capital financing through February 28, 2009. The GE facility consists of a revolving credit facility of up to \$156.0 million (including a \$20.0 million letter of credit

sub-facility) and a fully funded fixed term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) a specified percentage of eligible credit card receivables, and (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation performed by an independent appraiser. Such borrowings are further limited by a requirement to maintain a minimum of \$5.0 million of excess availability at all times, and other reserves that are in effect.

As of April 30, 2005, outstanding borrowings under the GE facility totaled \$63.7 million, and excess borrowing availability under the GE facility, after the deduction of the minimum availability requirement and other reserves, totaled \$56.4 million. Substantially all of the Company's assets, including its merchandise inventories, are pledged to GE Capital under the GE facility.

In January 2005, the Company amended the GE facility to provide for a springing lock-box arrangement. Pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement," the Company has classified all of its revolving credit facility as long-term as of April 30, 2005 and January 29, 2005. Although the Company has held the intent and ability to maintain this debt outstanding for more than one year, prior to such amendment the Company classified its borrowings under the facility as a current liability pursuant to such guidance. Accordingly, borrowings under the revolving credit facility as of May 1, 2004 are classified as current liabilities.

As of April 30, 2005, interest charged on amounts borrowed under the revolving portion of the GE facility are at the prime rate, or at the Company's option, at the applicable LIBOR rate plus 1.5% per annum, and interest charged on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion of the GE facility. The interest rate applicable to the revolving portion of the GE facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's daily average excess availability for the preceding fiscal quarter (as defined in the agreement). Under the pricing matrix, the applicable interest rate could range from a rate as low as prime plus 0.00% or LIBOR plus 1.50%, to as high as prime plus 0.75%, or LIBOR plus 2.75%.

The GE facility contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement). As of April 30, 2005, the Company was in compliance with all restrictive financial covenants applicable to the GE facility.

#### Long-Term Financings

The Company's long-term debt and capital lease obligations consist of the following:

(In thousands)	April 30, 2005	January 29, 2005	May 1, 2004
9.39% mortgage loans payable, due 2010.	16,939	17,059	17,403
Capital lease obligations.....	5,287	5,707	6,952
Variable rate note payable, due 2005...		3,700	3,700
7.5% note payable, due 2010.....	3,601		
Other mortgage loans and notes payable.	2,314	2,426	2,828
	28,141	28,892	30,883
Less current portion.....	3,243	3,242	2,590
	\$ 24,898	\$ 25,650	\$ 28,293

On February 14, 2005, the Company amended and extended the financing of its ownership interest in the partnership that owns the Company's corporate headquarters building. The related note payable of \$3.7 million, which originally provided for interest only payments at a variable rate of interest of prime plus 1.5% per annum, and was due in full upon maturity on May 24, 2005, has been modified to a fully amortizing note bearing interest at a fixed rate of 7.50% per annum and maturing on February 24, 2010. There is no prepayment penalty associated with the note.

Substantially all of the Company's assets, including its merchandise inventories, are pledged as collateral under the Company's various debt agreements. Certain of the Company's long-term debt agreements contain financial and other restrictive covenants. The Company was in compliance with all such covenants as of April 30, 2005.

#### Subordinated Note

On December 7, 2004, the Company issued a new Subordinated Note to Harris, a wholly owned subsidiary of El Corte Ingles ("ECI") of Spain, which superseded the original note. The new Subordinated Note, due May 30, 2009, bears interest at a fixed rate of 8% payable semi-annually and provides for principal payments of up to \$8.0 million prior to its maturity. Such payments are subject to certain liquidity restrictions under the GE facility. The Company made principal payments of \$1.0 million each upon execution of the note and on February 20, 2005 as scheduled. Additional principal payments of \$1.0 million are scheduled for each of February 2006 and 2007 and principal payments of \$2.0 million are scheduled for each of February 2008 and 2009, with the balance due at maturity subject to the payment in full of the GE facility. The Subordinated Note is unsecured, contains no restrictive financial covenants and is subordinate to the payment of all debt, including trade credit, of the Company.

#### 6. WEIGHTED AVERAGE NUMBER OF SHARES

Options with an exercise price greater than the average market price of the Company's common stock during the period, or outstanding in a period in which the Company reports a net loss, are excluded from the computation of the weighted average number of shares on a diluted basis, as such options are anti-dilutive. Weighted average options outstanding of approximately 1,501,000 and 1,000,000 were excluded from the computation of dilutive shares due to the Company's net loss position in the thirteen weeks ended April 30, 2005 and May 1, 2004. Had the Company reported profit for these periods, approximately 684,000 options with an exercise price greater than the average market price of the Company's common stock during the thirteen weeks ended May 1, 2004 would have been excluded from the computation of the weighted average number of shares, and the approximate effect of dilutive options would have been 674,000 shares and 391,000 shares for the thirteen weeks ended April 30, 2005 and May 1, 2004 respectively.

#### 7. COMMITMENTS AND CONTINGENCIES

On March 5, 2004, AT&T filed a breach of contract complaint in The United States District Court in Fresno, California demanding the payment of approximately \$768,000 for telecommunication services allegedly supplied to the Company in 2002 and 2003. The Company has answered and denied the AT&T allegations and demand. The Company believes that it is not liable for the amounts demanded by AT&T, however, it has accrued liabilities for estimated settlement costs that management believes are reasonable. Although the final resolution of these matters may be greater than the Company's recorded liability, management does not believe the ultimate resolution will have a material adverse effect on the Company's business, financial condition, or results of operations.

The Company is party to other legal proceedings and claims which arise during the ordinary course of business. In the opinion of management, the ultimate outcome of such litigation and claims are not expected to have a material adverse effect on the Company's financial position or results of its operations.

In July 2004, the Company entered into an agreement to open one new concept store in the River Park area of Fresno, California. The anticipated completion date of the project is Summer 2005 with an estimated net cost to the Company of approximately \$4.5 million. As of April 30, 2005, the estimated remaining cost of such project is \$1.8 million.

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As of April 30, 2005, the Company had issued a total of \$2.4 million of standby letters of credit and documentary letters of credit totaling \$0.7 million. Management believes that the likelihood of any draws under the standby letters of credit is remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The suppliers draw against the documentary letters of credit upon delivery of the merchandise to the Company's customs broker at a United States port.

8. RESTATEMENT OF FINANCIAL STATEMENTS

The Company has restated its fiscal 2004 quarterly financial information related to corrections to the Company's lease accounting policies, including an adjustment to depreciation expense to correct the depreciable lives being used for certain leasehold costs and improvements, and the recording of certain tenant allowances and construction reimbursements as reductions in rent expense, which are included in selling general and administration expenses, that had previously been recorded as reductions in the cost of the underlying constructed assets. In addition, the restatement includes adjusting lease terms of certain leases to include bargain renewal option periods where exercise of the options would be reasonably assured, and recognizing the straight-line effect over the lease term of such changes in rents during the option periods. Accordingly, the accompanying condensed financial statements as of and for the thirteen weeks ended May 1, 2004 have been restated from amounts previously reported.

A summary of the significant effects of the restatement is as follows:

<b>For the thirteen-weeks ended:</b>	<b>May 1, 2004</b>	<b>May 1, 2004</b>
-----	-----	-----
	(As previously reported)	(As restated)
Selling, general and administrative expenses.....	\$ 49,241	\$ 49,110
Depreciation and amortization.....	3,078	3,417
Operating loss.....	(1,014)	(1,222)
Loss from continuing operations before income tax benefit.....	(3,426)	(3,634)
Income tax benefit.....	(1,338)	(1,418)
Loss from continuing operations.....	(2,088)	(2,216)
Net loss.....	\$ (2,108)	\$ (2,236)
Net loss per common share:		
Basic and diluted		
Loss from continuing operations.....	\$ (0.16)	\$ (0.17)
Loss from discontinued operations.....	\$ 0.0	\$ 0.0
Net loss per common share.....	\$ (0.16)	\$ (0.17)

<b>Balance Sheet As of:</b>	<b>May 1, 2004</b>	<b>May 1, 2004</b>
-----	-----	-----
	(As previously reported)	(As restated)
Property and equipment, net.....	\$ 127,853	\$ 125,237
Other intangibles - net.....	842	680
Total other assets.....	5,865	6,535
Total assets.....	348,602	346,494
Trade accounts payable and other current liabilities.....	83,518	84,022
Deferred income taxes and other liabilities (long term).....	28,908	28,382
Total stockholders' equity.....	106,233	104,147
Total liabilities and stockholders' equity.....	\$ 348,602	\$ 346,494

## 9. RECENT ACCOUNTING PRONOUNCEMENTS

In December 2004, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123R (revised 2004), "Share-Based Payment" ("SFAS No. 123R") which revised SFAS No. 123, "Accounting for Stock-Based Compensation". This statement supercedes APB Opinion No. 25, "Accounting for Stock Issued to Employees". SFAS No. 123R addresses the accounting for share-based payment transactions with employees and other third parties, eliminates the ability to account for share-based compensation transactions using APB No. 25 and requires that the compensation costs relating to such transactions be recognized in the consolidated statement of operations. In April 2005, the SEC amended the compliance dates for SFAS No. 123R from fiscal periods beginning after June 15, 2005 to fiscal years beginning after June 15, 2005. The Company will continue to account for share-based compensation using the intrinsic value method set forth in APB No. 25 until adoption of SFAS No. 123R on January 29, 2006. The Company is currently evaluating the impact of adopting SFAS No. 123R.

## Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Following is management's discussion and analysis of significant factors which have affected the Company's financial position and its results of operations for the periods presented in the accompanying condensed financial statements. The Company's operating results, like those of most retailers, are subject to seasonal influences, with the major portion of sales, gross margin and operating results realized during the fourth quarter of each fiscal year. Accordingly, performance for the thirteen-week period ended April 30, 2005 (hereinafter referred to as the "first quarter of fiscal 2005"), is not necessarily indicative of performance for the remainder of the year.

The accompanying management's discussion and analysis of financial condition and results of operations gives effect to the restatement discussed in Note 8 of the accompanying condensed financial statements.

### Critical Accounting Policies

The Company's financial statements are based on the application of significant accounting policies, many of which require management to make significant estimates and assumptions. Some of these significant accounting policies involve a higher degree of judgment or complexity than its other accounting policies. The Company evaluates its estimates on an ongoing basis, including those related to its revenue recognition policy, the carrying value of its merchandise inventories, and the valuation of its long-lived assets, including goodwill, and its deferred tax assets. The impact and associated risks related to these policies on the Company's business operations are described more fully in the Company's 2004 Annual Report on Form 10-K.

### Results of Operations

The following table sets forth the Company's Statements of Operations as a percent of net sales:

	<b>Thirteen Weeks Ended</b>	
	<b>April 30, 2005</b>	<b>May 1, 2004</b>
Net sales.....	100.0 %	100.0 %
Net credit revenues.....	0.5	0.6
Net leased department revenues.....	0.5	0.5
Total revenues.....	101.1	101.1

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Costs and expenses:		
Cost of sales.....	66.1	65.6
Selling, general and administrative expenses.....	33.8	33.9
Depreciation and amortization.....	2.2	2.4
New store opening costs.....	0.1	0.0
	102.2	101.9
Operating loss.....	(1.1)	(0.8)
Other (income) expense:		
Interest expense.....	1.3	2.0
Miscellaneous income.....	(0.2)	(0.3)
	1.1	1.7
Loss before income tax benefit.....	(2.2)	(2.5)
Income tax benefit.....	(0.8)	(1.0)
	(1.4)	(1.5)
Discontinued operations:		
Loss on store closures.....	0.0	0.0
Income tax benefit.....	0.0	0.0
	0.0	0.0
Loss on discontinued operations.....	0.0	0.0
	(1.4) %	(1.5) %
	(1.4) %	(1.5) %

### First Quarter of Fiscal 2005 Compared to First Quarter of Fiscal 2004

#### Net Sales

Net sales decreased by approximately \$0.4 million to \$144.1 million in the first quarter of fiscal 2005 as compared to \$144.5 million in the first quarter of fiscal 2004, a decrease of 0.3%. Severe west coast weather and rising fuel prices put pressure on consumer spending for the period. In addition, the Company launched its 100<sup>th</sup> Anniversary marketing campaign in March of fiscal 2004, which helped push sales last year. Comparable store sales for the first quarter of fiscal 2005, which includes sales for stores open for the full period in both years, decreased by 0.6% as compared to the first quarter of fiscal 2004.

The Company operated 63 department stores and 6 specialty stores as of the end of the first quarter of fiscal 2005, as compared to 63 department stores and 10 specialty stores as of the end of the first quarter of fiscal 2004.

#### Net Credit Revenues

Net credit revenues related to the Company's proprietary credit cards decreased approximately \$0.1 million, or 7.2%, in the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004. As a percent of net sales, net credit revenues was 0.5% of net sales in the first quarter of fiscal 2005 as compared to 0.6% in the first quarter of fiscal 2004. The decrease in net credit revenues is due to lower recoveries on accounts charged off prior to the sale of the portfolio to HSBC.

#### Net Leased Department Revenues



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Net rental income generated by the Company's various leased departments in the first quarter of fiscal 2005 was virtually equal to the first quarter of fiscal 2004.

Leased department sales are presented net of the related costs for financial reporting purposes. Sales generated in the Company's leased departments in the first quarter of fiscal 2005 consisted primarily of sales in the fine jewelry departments and the beauty salons. These leased department sales were \$5.3 million in both the first quarter of fiscal 2005 and the first quarter of fiscal 2004.

### Cost of Sales

Cost of sales, which includes costs associated with the buying, handling and distribution of merchandise, increased by approximately \$0.4 million to \$95.2 million in the first quarter of fiscal 2005 as compared to \$94.8 million in the first quarter of fiscal 2004, an increase of 0.4%. The Company's gross margin percentage decreased to 33.9% in the first quarter of fiscal 2005 as compared to 34.4% in the first quarter of fiscal 2004. The decrease in gross margin is mainly due to the decrease in net sales combined with higher markdowns taken earlier in the quarter in an effort to drive sales.

### Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased by approximately \$0.4 million to \$48.7 million in the first quarter of fiscal 2005 as compared to \$49.1 million in the first quarter of fiscal 2004, a decrease of 0.8%. The decrease is primarily attributable to a stabilization of worker's compensation costs, which were impacted by significant increases in loss development rates in California last year. As a percent of net sales, selling, general and administrative expenses decreased in the first quarter of fiscal 2005 by 0.1% as compared to the first quarter of fiscal 2004.

### Depreciation and Amortization

Depreciation and amortization expense, which includes the amortization (accretion) of intangible assets other than goodwill, was \$3.2 million in the first quarter of fiscal 2005 as compared to \$3.4 million in the first quarter of fiscal 2004. As a percent of net sales, depreciation and amortization expense decreased to 2.2% in the first quarter of fiscal 2005 as compared to 2.4% in the first quarter of fiscal 2004. These decreases are partially due to certain assets becoming fully depreciated, partially offset by new assets put into service since the end of the first quarter of fiscal 2004.

### Interest Expense

Interest expense, which includes the amortization of deferred financing costs, decreased by approximately \$1.0 million to \$1.9 million in the first quarter of fiscal 2005 as compared to \$2.9 million in the first quarter of fiscal 2004, a decrease of 32.9%. As a percent of net sales, interest expense decreased to 1.3% in the first quarter of fiscal 2005 as compared to 2.0% in the first quarter of fiscal 2004. These decreases are primarily due to continued total debt reductions of \$17.9 million at the end of the first quarter of fiscal 2005 as compared to the end of the first quarter of fiscal 2004. These interest reductions include one-time charges of \$0.4 million for the early termination of certain debt in the first quarter of fiscal 2004 in connection with the amendment and extension of the Company's revolving credit facility. The weighted average interest rate applicable to the revolving credit facility was 5.6% in the first quarter of fiscal 2005 (5.4% at April 30, 2005) as compared to 4.7% in the first quarter of fiscal 2004.

### Miscellaneous Income - Net

Miscellaneous income, which includes the amortization of deferred income and other non-operating income and expense amounts, was \$0.4 million in the first quarter of fiscal 2005 and \$0.5 million in the first quarter of fiscal 2004.

### Income Taxes

The Company's interim effective tax benefit rates from continuing operations of 38.0% in the first quarter of fiscal 2005 and 39.0% in the first quarter of fiscal 2004 relate to the net losses incurred in those periods and represent the Company's best estimates of the annual effective tax rates for those fiscal periods.

#### Discontinued Operations

Net costs associated with the closure of stores were minor in the quarter ended May 1, 2004, primarily consisting of incremental costs associated with the closure of one store at January 31, 2004. The closure of the Company's Fig Garden Store is not considered a discontinued operation due to its proximity with three other larger stores in the Fresno market, as well as the planned opening of the Fresno River Park store in Summer 2005.

#### Net Loss

As a result of the foregoing, the Company reported a net loss of approximately \$2.0 million in the first quarter of fiscal 2005 as compared to net loss of \$2.2 million in the first quarter of 2004. On a per share basis (basic and diluted), the net loss was \$0.15 per share in the first quarter of 2005 as compared to \$0.17 per share in the first quarter of 2004.

#### Liquidity and Capital Resources

As described more fully in the Company's 2004 Annual Report on Form 10-K and Note 5 to the accompanying financial statements, the Company's working capital requirements are currently met through a combination of cash provided by operations, borrowings under its senior revolving credit facility, and by short-term trade and factor credit. The Company's liquidity position, like that of most retailers, is affected by seasonal influences, with the greatest portion of cash from operations generated in the fourth quarter of each fiscal year.

The Company's use of cash in operations during the first quarter is primarily the result of the build-up of spring and summer inventory, after the winter holiday selling season. The increase in net cash used in operations for the first quarter of fiscal 2005 as compared to the first quarter of fiscal 2004 is primarily due to increases in the Company's estimated income tax payments.

Increases in net cash used in investing activities are the result of additional capital spending related to the opening of the Company's Albany, Oregon store and construction of the Fresno, California, River Park store.

Net cash provided by financing activities during the first quarter primarily relates to increased borrowing on the Company's revolving line of credit to fund the acquisition of inventory and for capital expenditures, partially offset by ongoing payment of principal on long-term obligations. The first quarter of fiscal 2004 included the early termination of certain high interest debt, which was partially funded through a lower fixed interest term note that is part of the amended GE facility described below.

#### Sources of Liquidity

##### Senior Secured Credit Facility

On February 1, 2002, the Company entered into a three-year senior revolving credit facility with General Electric Capital Corporation ("GE Capital") as agent and lender, along with three other lenders (the "Original GE facility"). On March 1, 2004, the Company finalized an amendment and restatement of the Original GE facility (the "GE facility"). The GE facility provides up to \$165.0 million of working capital financing February 28, 2009. The GE facility consists of a revolving credit facility of up to \$156.0 million (including a \$20.0 million letter of credit sub-facility) and a fully funded fixed term loan of \$9.0 million. Borrowings under the revolving credit facility are limited to the sum of (a) a specified percentage of eligible credit card receivables, and (b) the lesser of specified percentages of (i) the cost of eligible inventory and (ii) the net recovery value of the inventory, as determined by periodic valuation

performed by an independent appraiser. Such borrowings are further limited by a requirement to maintain a minimum of \$5.0 million of excess availability at all times, and other reserves that are in effect.

As of April 30, 2005, outstanding borrowings under the GE facility totaled \$63.7 million, and excess borrowing availability under the GE facility, after the deduction of the minimum availability requirement and other reserves, totaled \$56.4 million. Substantially all of the Company's assets, including its merchandise inventories, are pledged to GE Capital under the GE facility.

In January 2005, the Company amended the GE facility to provide for a springing lock-box arrangement. Pursuant to guidance in the Financial Accounting Standards Board's Emerging Issues Task Force Issue No. 95-22, "Balance Sheet Classification of Borrowings Outstanding Under Revolving Credit Agreements that include both a Subjective Acceleration Clause and a Lock-Box Arrangement," the Company has classified all of its revolving credit facility as long-term as of April 30, 2005 and January 29, 2005. Although the Company has held the intent and ability to maintain this debt outstanding for more than one year, prior to such amendment the Company classified its borrowings under the facility as a current liability pursuant to such guidance. Accordingly, borrowings under the revolving credit facility as of May 1, 2004 are classified as current liabilities.

As of April 30, 2005, interest charged on amounts borrowed under the revolving portion of the GE facility are at the prime rate, or at the Company's option, at the applicable LIBOR rate plus 1.5% per annum, and interest charged on the term loan is a fixed rate of 6.6% per annum. In addition, the Company pays an unused commitment fee equal to 0.375% per annum on the average unused daily balance of the revolving portion of the GE facility. The interest rate applicable to the revolving portion of the GE facility is adjusted upwards or downwards on a quarterly basis based on a pricing matrix which is tied to the Company's daily average excess availability for the preceding fiscal quarter (as defined in the agreement). Under the pricing matrix, the applicable interest rate could range from a rate as low as prime plus 0.00% or LIBOR plus 1.50%, to as high as prime plus 0.75%, or LIBOR plus 2.75%.

The GE facility contains restrictive financial and operating covenants, including the requirement to maintain a fixed charge coverage ratio of 1:1 (as defined in the agreement). As of April 30, 2005, the Company was in compliance with all restrictive financial covenants applicable to the GE facility.

#### Trade Credit

The success of the Company's business is partially dependent upon the adequacy of trade credit offered by key factors and vendors, the vendors' ability and willingness to sell its products at favorable prices and terms, and the willingness of vendors to ship merchandise on a timely basis. The Company has been able to purchase adequate levels of merchandise to support its operations and expects the level of trade credit to be sufficient to support its operations in the foreseeable future. Restrictions to the amount of trade credit granted by key factors and vendors can adversely impact the volume of merchandise the Company is able to purchase. Any significant reduction in the volume of merchandise the Company is able to purchase, or a prolonged disruption in the timing of when merchandise is received, could have a material adverse affect on the Company's business, liquidity position, and results of operations.

#### Other Financings

On February 14, 2005, the Company amended and extended the financing of its ownership interest in the partnership that owns the Company's corporate headquarters building. The related note payable of \$3.7 million, which originally provided for interest only payments at a variable rate of interest of prime plus 1.5% per annum, and was due in full upon maturity on May 24, 2005, has been modified to a fully amortizing note bearing interest at a fixed rate of 7.50% per annum and maturing on February 24, 2010. There is no prepayment penalty associated with the note.

The Company may consider various other sources of liquidity in the future, including but not limited to the issuance of additional securities that might have a dilutive effect on existing shareholders or incurring additional indebtedness

which would increase the Company's leverage.

#### Uses of Liquidity

The Company's primary uses of liquidity are for working capital, debt service requirements and capital expenditures. Capital expenditures in the first quarter of fiscal 2005, totaling \$4.2 million, were primarily related to the fixturing of the Albany Oregon store and construction on the River Park store.

In July 2004, the Company entered into an agreement to open one new concept store in the River Park area of Fresno, California. The anticipated completion date of the project is Summer 2005 with an estimated net cost to the Company of approximately \$4.5 million. As of April 30, 2005, the estimated remaining cost of such project is \$1.8 million.

As of April 30, 2005, the Company had issued a total of \$2.4 million of standby letters of credit and documentary letters of credit totaling \$0.7 million. The standby letters of credit were issued to provide collateral for workers compensation insurance policies. Management believes that the likelihood of any draws under the standby letters of credit is remote. Documentary letters of credit are issued in the ordinary course of business to facilitate the purchase of merchandise from overseas suppliers. The supplier draws against the documentary letter of credit upon delivery of the merchandise.

Subject to the previously described risks and uncertainties relative to the Company's sources of liquidity, management currently believes that the described sources of liquidity, including cash generated by operations, liquidity provided by the GE facility and other financial resources, will be adequate to meet the Company's planned cash requirements for at least the next 12 months. However, the Company's actual results may differ from the expectations set forth in the preceding sentence. The Company's liquidity and capital resources may be affected by a number of factors and risks (many of which are beyond the control of the Company), including but not limited to the availability of adequate borrowing capacity, adequate cash flows generated by operations and the adequacy of factor and trade credit. If the estimates or assumptions relative to any one of these sources of liquidity are not realized, or if these sources of liquidity are significantly reduced or eliminated, the Company's liquidity position, financial condition and results of operations will be materially adversely affected.

#### Safe Harbor Statement

Certain statements contained in this Quarterly Report on Form 10-Q are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 and the Company intends that such forward-looking statements be subject to the safe harbors created thereby. These forward-looking statements include the plans and objectives of management for future operations and the future economic performance of the Company that involve risks and uncertainties. In some instances, such statements may be identified by the use of forward-looking terminology such as "may," "will," "expects," "believes," "intends," "projects," "forecasts," "plans," "estimates," "anticipates," "continues," "targets," or similar terms, variations of such terms or the negative of such terms. Such statements are based on management's current expectations and are subject to a number of factors and uncertainties which could cause actual results to differ materially from those described in the forward-looking statements, including, without limitation, the Company's ability to meet debt obligations and adhere to the restrictions and covenants imposed under its various debt agreements; the timely receipt of merchandise and the Company's ability to obtain adequate trade credit from its key factors and vendors; risks arising from general economic and market conditions (including uncertainties arising from future acts of terrorism or war); the ability to modify operations in order to minimize the adverse impact of rising costs, including but not limited to health care, workers' compensation, property and casualty insurance, unemployment insurance, and utilities costs; the effects of seasonality and weather conditions, changing consumer trends and preferences, competition, consumer credit; the Company's dependence on its key personnel; and general labor conditions, all of which are described in more detail under the caption "Risk Factors" in Item I. "Business" in the Company's 2004 Annual Report on Form 10-K and other reports filed by the Company with the Securities and Exchange Commission. THE COMPANY DOES NOT

PRESENTLY INTEND TO UPDATE THESE STATEMENTS AND UNDERTAKES NO DUTY TO ANY PERSON TO EFFECT ANY SUCH UPDATE UNDER ANY CIRCUMSTANCES.

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

As described more fully in Part II, Item 7A of the Company's 2004 Annual Report on Form 10-K, the Company is exposed to market risks in the normal course of business due to changes in interest rates on short-term borrowings under its revolving line of credit and on certain of its long-term borrowing arrangements. Based on current market conditions, management does not believe there has been a material change in the Company's exposure to interest rate risks as described in that report.

### Item 4. CONTROLS AND PROCEDURES

#### Evaluation of Disclosure Controls and Procedures

The Company maintains "disclosure controls and procedures," as such term is defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), that are designed to ensure that information required to be disclosed in the Company's reports, pursuant to the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding the required disclosures. In designing and evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurances of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost benefit relationship of possible controls and procedures.

The Company's Chief Executive Officer and Chief Financial Officer (its principal executive officer and principal financial officer, respectively), with the participation of the Company's management, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as of April 30, 2005. Based on their evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective.

#### Changes in Internal Controls Over Financial Reporting

During the first quarter of 2005, the Company remediated a material weakness in internal control over financial reporting and the ineffectiveness of its disclosure controls and procedures by conducting a review of its accounting related to leases, and correcting its method of accounting for tenant improvement allowances, lease terms and depreciable lives used for leasehold costs and improvements, resulting in the restatement of the Company's financial statements for the quarter ended May 1, 2004, included in this Quarterly Report on Form 10-Q.

The evaluation referred to above did not identify any other significant change in the Company's internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II - OTHER INFORMATION

### Item 2. CHANGES IN SECURITIES, USE OF PROCEEDS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company's senior revolving credit agreement with GE Capital prohibits the Company from paying dividends without prior written consent from the lenders.

Item 6. EXHIBITS

<u>Exhibit Number</u>	<u>Exhibit Description</u>
3.1	Certificate of Incorporation of the Company, as amended. (1)
3.2	Bylaws of the Company, as amended. (2)
31.1	Section 302 Certification of Chief Executive Officer. (3)
31.2	Section 302 Certification of Chief Administrative and Financial Officer. (3)
32.1	Certification of President and Chief Executive Officer and Chief Administrative and Financial Officer Pursuant to 18 U.S.C. §1350, As Adopted Pursuant to §906 of the Sarbanes-Oxley Act of 2002. (3)

(1) Previously filed as an exhibit to Registration Statement on Form S-1 (File No. 33-3949).

(2) Previously filed as an exhibit to the Annual Report on Form 10-K for the year ended February 3, 2001 (File No. 1-09100).

(3) Furnished concurrently herewith.

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**SIGNATURES**

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

Gottschalks Inc.  
(Registrant)

June 10, 2005      By:                      /s/ James R. Famalette  
James R. Famalette  
(President and Chief Executive Officer)

June 10, 2005      By:                                      /s/ J. Gregory Ambro  
J. Gregory Ambro  
(Senior Vice President/Chief Administrative and Financial Officer)

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