

NITCHES INC
Form 10-Q
January 14, 2003

**SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

Form 10-Q

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

For the quarterly period ended: November 30, 2002

Commission File Number 0-13851

NITCHES, INC.

(Exact name of registrant as specified in its charter)

California
(State of Incorporation)

95-2848021
(I.R.S. Employer Identification No.)

10280 Camino Santa Fe, San Diego, California 92121
(Address of principal executive offices)

Registrant's telephone number: (858) 625-2633

Securities registered pursuant to Section 12(b) of the Act:

| Title of each class | Name of each exchange on which registered |
|----------------------------|---|
| Common Stock, no par value | NASDAQ SmallCap Market |

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 [X] No []

As of November 30, 2002 the Registrant had 1,171,169 shares of common stock outstanding.

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

NITCHES, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets

ASSETS

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ASSETS

| | November 30, 2002 | August 31, 2002 |
|--|-------------------------|--------------------|
| Current assets: | | |
| Cash and cash equivalents | \$ 170,000 | \$ 182,000 |
| Receivables: | | |
| Trade accounts, less allowances | 3,980,000 | 4,413,000 |
| Due from affiliates and employees | 106,000 | 110,000 |
| Total receivables | 4,086,000 | 4,523,000 |
| Refundable income taxes | 79,000 | 118,000 |
| Inventories | 3,334,000 | 5,306,000 |
| Deferred income taxes | 252,000 | 143,000 |
| Other current assets | 110,000 | 106,000 |
| Total current assets | 8,031,000 | 10,378,000 |
| Investment in Designer Intimates, Inc. | 288,000 | |
| Furniture, fixtures and equipment, net | 77,000 | 85,000 |
| Deferred income taxes | 23,000 | 23,000 |
| Other assets | 17,000 | 17,000 |
| | \$ 8,436,000 | \$ 10,503,000 |

LIABILITIES AND SHAREHOLDERS EQUITY

| | | |
|--|--------------|---------------|
| Current liabilities: | | |
| Accounts payable | \$ 1,595,000 | \$ 4,133,000 |
| Accrued expenses | 214,000 | 144,000 |
| Total current liabilities | 1,809,000 | 4,277,000 |
| Shareholders' equity: | | |
| Preferred stock, no par value; 25,000,000 shares authorized, no shares issued or outstanding | | |
| Common stock, no par value; 50,000,000 shares authorized; 1,171,169 shares issued and outstanding | 1,495,000 | 1,495,000 |
| Retained earnings | 5,132,000 | 4,731,000 |
| Total shareholders' equity | 6,627,000 | 6,226,000 |
| | \$ 8,436,000 | \$ 10,503,000 |

The accompanying notes are an integral part of these financial statements

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| | Three months ended November 30, | |
|--|--|--------------|
| | 2002 | 2001 |
| Net sales | \$ 10,435,000 | \$ 9,895,000 |
| Cost of goods sold | 8,500,000 | 7,784,000 |
| Gross profit | 1,935,000 | 2,111,000 |
| Selling, general and administrative expenses | 1,802,000 | 1,813,000 |
| Income from operations | 133,000 | 298,000 |
| Interest expense, net | (29,000) | (37,000) |
| Income from unconsolidated subsidiary | 288,000 | |
| Income before income taxes | 392,000 | 261,000 |
| Provision/(benefit) for income taxes | (68,000) | 102,000 |
| Net income | \$ 460,000 | \$ 159,000 |
| Earnings per share (basic and diluted) | \$ 0.39 | \$ 0.15 |
| Shares outstanding (basic and diluted) | 1,171,169 | 1,064,680 |

The accompanying notes are an integral part of these financial statements

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NITCHES, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Unaudited)

| | Three months ended November 30, | |
|--|--|-------------|
| | 2002 | 2001 |
| Net cash provided by operating activities | \$ (12,000) | \$ 209,000 |
| Cash flows from investing activities: | | |
| Capital expenditures | | (40,000) |
| Cash flows from financing activities: | | |
| Dividends paid | | (159,000) |
| Net increase (decrease) in cash and cash equivalents | (12,000) | 10,000 |
| Cash and cash equivalents at beginning of period | 182,000 | 192,000 |
| Cash and cash equivalents at end of period | \$ 170,000 | \$ 202,000 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period: | | |
| Interest | \$ 29,000 | \$ 37,000 |
| Income taxes | | 4,000 |
| Non-cash investing activity: | | |
| Accrued earnings of unconsolidated subsidiary | \$ 288,000 | \$ |

The accompanying notes are an integral part of these financial statements

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NITCHES, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

1. Description of Business

Nitches, Inc. (the Company) is a wholesale importer and distributor primarily of women's clothing manufactured to its specifications and distributed in the United States under Company brand labels and private retailer labels.

2. Condensed Financial Statements:

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q. They do not include all information and footnotes necessary for a fair presentation of financial position and results of operations and cash flows in conformity with generally accepted accounting principles. These consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes contained in the Company's Annual Report on Form 10-K for the year ended August 31, 2002. In the opinion of Management, all adjustments considered necessary for a fair presentation have been included in the interim period. Operating results for the three months ended November 30, 2002 are not necessarily indicative of the results that may be expected for the year ending August 31, 2003.

3. Earnings Per share:

At November 30, 2002, there were no stock options or similar instruments outstanding and therefore no dilutive effect to the weighted average number of shares outstanding.

4. Inventories:

| | November 30, 2002 | August 31, 2002 |
|------------------|----------------------|--------------------|
| Fabric and trim | \$ 224,000 | \$ 55,000 |
| Work in progress | | 27,000 |
| Finished goods | 3,110,000 | 5,224,000 |
| | \$ 3,334,000 | \$ 5,306,000 |

5. Trade accounts receivable:

Pursuant to the terms of an agreement between Nitches and a factor, Nitches sells a majority of its trade accounts receivable to the factor on a pre-approved, non-recourse basis. The Company may request advances in anticipation of customer collections and open letters of credit through the factor, all of which are collateralized by all of the Company's assets. Outstanding advances are charged interest at the factor's prime rate less one half percent. Advances and contingent liabilities for irrevocable letters of credit outstanding are as follows:

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NITCHES, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statement (continued)

5. Trade accounts receivable (continued):

| | November 30, 2002 | August 31, 2002 |
|--|----------------------|--------------------|
| Receivables assigned to factor: | | |
| Non-recourse | \$ 8,956,000 | \$ 4,115,000 |
| Recourse | 122,000 | 176,000 |
| Advances from factor | (4,887,000) | (10,000) |
| | <hr/> | <hr/> |
| Due from factor | 4,191,000 | 4,281,000 |
| Non-factored accounts receivable | 311,000 | 369,000 |
| Allowance for customer credits and doubtful accounts | (522,000) | (237,000) |
| | <hr/> | <hr/> |
| | \$ 3,980,000 | \$ 4,413,000 |
| | <hr/> | <hr/> |
| Contingent liabilities for irrevocable letters of credit | \$ 2,002,000 | \$ 7,156,000 |
| | <hr/> | <hr/> |

The factoring agreement allows the Company to borrow up to \$15,000,000, limited by certain percentages of outstanding accounts receivable and finished goods inventory owned by the Company. The Company's Chairman has provided a \$1,000,000 personal guarantee in connection with the factoring arrangement.

6. Dividends:

The Company paid a dividend of \$.05 (fifteen cents) per share on December 13, 2002 for a total of approximately \$59,000, to the shareholders of record as of November 29, 2002. During fiscal 2002 the Company declared and paid dividends of \$.45 per share.

7. Significant Customers:

Sales to three separate customers (Kohl's, Sears and Mervyn's) accounted for 31.0%, 24.2% and 26.9%, respectively, of the Company's net sales in the three months ended November 30, 2002. Two customers (Mervyn's and Kohl's) accounted for 47.6% and 27.2% of the Company's net sales in the three months ended November 30, 2001.

Three customers (Kohl's, Sears and Mervyn's) accounted for 36.0%, 29.2% and 27.4% respectively, of the Company's trade receivable balance at November 30, 2002. Two customers (Mervyn's and Kohl's) accounted for 54.2% and 28.4% of the Company's trade receivable balance at November 30, 2001.

8. Investment in Unconsolidated Subsidiary:

In October 2002 the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guarantee formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For October and November, the Company recognized \$288,000 in income from the unconsolidated subsidiary. This income is reported net of tax and is not taxable to the Company. For that same period, Designer Intimates had net income of \$1.0 million on sales of \$26.7 million. This compares to net income of \$413,000 on sales of \$16.6 million for the year earlier period.

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

Results of Operations

Three Months Ended November 30, 2002 Compared to the Three Months Ended November 30, 2001

Net sales for the three months ended November 30, 2002 increased approximately \$540,000 (5.5%) as compared to the three months ended November 30, 2001. This increase was attributable to an increase in unit sales in the Company's sleepwear product line.

Cost of sales as a percent of net sales increased 2.8%, generating a lower gross profit margin of 18.5% for the three months ended November 30, 2002 as compared to 21.3% for the year earlier period. The decrease came as the result of lower realized gross margins due to deflationary pricing pressures (see Impact of Inflation and Deflation below), as well as increased transportation and handling costs incurred due to rerouting of shipments as a result of the West Coast port lockout in October 2002. Furthermore, the Company's product mix constantly changes to reflect customer mix, fashion trends and changing seasons. Consequently, gross margin is likely to vary on a quarter-to-quarter basis and in comparison to gross margins generated in the same period of prior fiscal years.

Selling, general and administrative expenses remained relatively unchanged for the first quarter of fiscal 2003 as compared to a year ago. Expenses decreased as a percent of net sales from 17.8% in the year earlier period to 17.3% in the current period, due to the increase in net sales from the earlier period.

The Company's income tax provision reflects the effect of \$41,000 accrued tax expense for the first quarter of fiscal 2003 less the elimination of a deferred tax reserve in the amount of \$109,000, for a net tax benefit of \$68,000.

Investment in Unconsolidated Subsidiary

In October 2002 the Company acquired a 28% interest in Designer Intimates, Inc., which owns 100% of NAP, Inc., a New York-based intimate apparel company. Designer Intimates had acquired NAP from its founders and obtained a credit line of approximately \$12 million from HSBC, secured by the inventory and accounts receivable of NAP and the guarantees of shareholders of Designer Intimates. Nitches guaranteed \$3 million of this credit line and this guarantee formed the consideration from Nitches for its 28% ownership interest in Designer Intimates. Nitches reports any income or loss from the ongoing operation of Designer Intimates using the equity method of accounting, whereby Nitches' 28% interest in Designer Intimates is reported as a single line item on the Consolidated Statement of Income. For October and November, the Company recognized \$288,000 in income from the unconsolidated subsidiary. This income is reported net of tax and is not taxable to the Company. For that same period, Designer Intimates had net income of \$1.0 million on sales of \$26.7 million. This compares to net income of \$413,000 on sales of \$16.6 million for the year earlier period.

Liquidity and Capital Resources

Working capital rose slightly to \$6.2 million at November 30, 2002 from \$6.1 million at August 31, 2002, and the current ratio increased to 4.4:1 at November 30, 2002 from 2.43:1 at August 31, 2002.

The Company declared a dividend of \$.05 (five cents) per share to shareholders of record as of November 29, 2002, for a total of approximately \$59,000. This dividend was paid on December 13, 2002.

The Company sells substantially all of its trade receivables to a factor (CIT) on a pre-approved, non-recourse basis. The Company attempts to make any recourse shipments on a COD basis or ensure that the customers' payments are backed by a commercial or standby letter of credit issued by the customers' bank. The amount of the Company's receivables that were recourse and were not made on a COD basis or supported by commercial or standby letters of credit at November 30, 2002 was approximately \$433,000 of which approximately \$94,000 had been collected through January 3, 2003.

Payment for non-recourse factored receivables is made at the time customers make payment to CIT or, if a customer is financially unable to make payment, within approximately 180 days of the invoice due date. Under the Discount Factoring Agreement, the Company can request advances in anticipation of customer collections at CIT's prime rate (currently 4.25%) less one-half percent, and open letters of credit through CIT. The amount of borrowings by the Company, including a portion of outstanding letters of credit, are limited to certain percentages of outstanding accounts receivable and finished goods inventory

owned by the Company. Borrowings are collateralized by all of the assets of the Company. At November 30, 2002, the Company had outstanding letters of credit of approximately \$2.0 million for the purchase of finished goods, which had been opened through CIT. Either party may terminate the Discount Factoring Agreement on 60-days written notice.

Inventory

In its ordinary course of operations, the Company generally makes some sales below its normal selling prices or below cost. Based on prior experience, management believes this will be true for some inventory held on or acquired after November 30, 2002. The amount of such sales depends on several factors, including general economic conditions, market conditions within the apparel industry, the desirability of the styles held in inventory and competitive pressures from other garment suppliers.

The Company's inventory decreased from \$5.3 million at August 31, 2002 to \$3.3 million at November 30, 2002. The Company has established an inventory markdown reserve as of November 30, 2002, which management believes will be sufficient for current inventory that is expected to sell below cost in the future. There can be no assurance that the Company will realize its expected selling prices, or that the inventory markdown reserve will be adequate, for items in inventory as of November 30, 2002 for which customer sales orders have not yet been received. The inventory markdown reserve is calculated based on specific identification of aged goods and styles that are slow-moving or selling off-price.

Backlog

The Company had unfilled customer orders of \$9.3 million at November 30, 2002 compared to \$9.5 million at November 30, 2001, with such orders generally scheduled for delivery by May 2003 and May 2002, respectively. Reduced orders in the sleepwear product line contributed to the decrease in backlog of \$200,000. These amounts include both confirmed and unconfirmed orders that the Company believes, based on industry practice and past experience, will be confirmed. While cancellations, rejections and returns have generally not been material in the past, there can be no assurance that cancellations, rejections and returns will not reduce the amount of sales realized from the backlog of orders at November 30, 2002. Because of the Company's reliance upon a few major accounts, any adverse impact of the current economic downturn on one or more of these customers could lead to the cancellation of existing orders and/or an inability to secure future orders, which would have a material adverse financial effect on the Company. Sears has advised the Company that they are going to directly import their sleepwear for Spring 2003. This has the potential of reducing sleepwear volume for the Company by approximately \$1.1 million.

Impact of Exchange Rates

While the Company purchases over 90% of its products from foreign manufacturers, all of its purchases are denominated in United States dollars. Because the Company's products are sold primarily in the United States, in dollar denominated transactions, the Company does not engage in hedging or other arbitrage to reduce currency risk. An increase in the value of the dollar versus foreign currencies could enhance the Company's purchasing power for new purchase orders and reduce its cost of goods sold. Conversely, a decrease in the value of the dollar relative to foreign currencies could result in an increase in the Company's cost of manufacturing for new purchase orders and costs of goods sold.

Impact of Inflation and Deflation

Management does not believe that inflation has had any material impact upon the Company's revenues or income from operations to date. Management believes that the apparel sector in which the Company operates has been in a period of deflation, contrary to the modest inflation experienced in the economy in general. The persistence of the consumer to buy on sale merchandise has put pressure on retail gross margins, which in turn has led to downward pressure from retailers on wholesale gross margins, in the form of selling cost adjustments taken as deductions against invoices issued by the Company. In the apparel industry, these are commonly referred to as markdown allowances or chargebacks. Without a corresponding decrease in fabric and labor prices, these markdown allowances have led to a decline in wholesale gross margins. Management believes these modest deflationary pressures will continue into the foreseeable future.

Cautionary Statement Under the Private Securities Litigation Reform Act of 1995

Statements in the quarterly report on Form 10-Q under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations", as well as oral statements that may be made by the Company or by officers, directors or employees of the Company acting on the Company's behalf, that are not historical fact constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements involve known and unknown risks and uncertainties that may cause the Company's actual results in future periods to differ materially from forecasted results. Those risks include a softening of retailer or consumer acceptance of the Company's products, pricing pressures and other competitive forces, or unanticipated loss of a major customer. In addition, the Company's business, operations and financial condition are subject to reports and statements filed from time to time with the Securities and Exchange Commission.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There were no material legal proceedings to which the Company or any of its subsidiaries was a party in the three months ended November 30, 2002.

Item 6. Exhibits and Reports on Form 8-K

The Company filed a Current Report on Form 8-K on November 1, 2002, announcing its acquisition of a 28% interest in Designer Intimates, Inc.

SIGNATURES

Pursuant to the requirement of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned there unto duly authorized.

NITCHES, INC.

(Registrant)

January 14, 2003

By: /s/ Steven P. Wyandt

Steven P. Wyandt
As Principal Financial Officer and on
behalf of the Registrant

CERTIFICATIONS

I, Steven P. Wyandt, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Nitches, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report; and

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3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report.

Date: January 14, 2003

/s/ Steven P. Wyandt

Steven P. Wyandt
Chief Executive Officer and
Chief Financial Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Steven P. Wyandt, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Nitches, Inc. on Form 10-Q for the three months ended November 30, 2002 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Nitches, Inc.

By: /s/ Steven P. Wyandt

Name: Steven P. Wyandt
Title: Chief Executive Officer and Chief Financial Officer