MCRAE INDUSTRIES INC
Form 10-Q
March 16, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(x) Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the Quarter Ended January 31, 2004.

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 1-8578

McRae Industries, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**56-0706710**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

400 North Main Street
Mt. Gilead, North Carolina 27306
(Address of principal executive offices)

Telephone Number (910) 439-6147
(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 periods 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 ( )

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

Yes ( ) No (X)

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practical date.

Common Stock, $l Par Value	Class A	1,935,443 shares as of March 11, 2004.
Common Stock, $1Par Value	Class B	833,556 shares as of March 11, 2004.

McRae Industries, Inc. and Subsidiaries

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PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

McRae Industries, Inc. and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEET
ASSETS
(In thousands, except share and per share data)

	January 31, 2004	August 2, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 4,113	$ 6,192
Accounts and notes receivable, net	9,971	10,334
Inventories (see Note B)	15,853	17,559
Net investment in capitalized leases	146	146
Prepaid income taxes	1,399	314
Prepaid expenses and other current assets	560	242
Total current assets	32,042	34,787
Property and equipment, net	5,015	4,541
Other assets:		
Net investment in capitalized leases	1,613	1,716
Notes receivable	40	71
Real estate held for investment	1,449	1,390
Goodwill	362	362
Cash surrender value of life insurance	2,220	2,220
Trademarks	1,049	1,049
Other	12	13
Total other assets	6,745	6,821
Total Assets	$ 43,802	$46,149

See notes to condensed consolidated financial statements

McRae Industries, Inc. and Subsidiaries
CONDENSED CONSOLIDATED BALANCE SHEET
LIABILITIES AND SHAREHOLDERS EQUITY

(In thousands, except share and per share data)

	January 31, 2004	August 2, 2003
Liabilities and Shareholders Equity		
Current liabilities:		
Notes payable, banks - current portion	$ 577	$ 577
Accounts payable	3,424	5,211
Accrued employee benefits	194	427
Deferred revenues	671	1,012
Accrued payroll and payroll taxes	885	913
Contract contingencies	400	400
Other	1,073	1,044
Total current liabilities	7,224	9,584
Notes payable, banks, net of current portion	3,022	3,307
Lease guarantees	1,552	1,568
Minority interest	83	88
Commitment and contingencies		
Shareholders equity:		
Common stock:		
Class A, $1 par; Authorized 5,000,000 shares; Issued and outstanding, 1,929,943 and 1,914,972 shares, respectively	1,930	1,915
Class B, $1 par; Authorized 2,500,000 shares; Issued and outstanding, 838,556 and 853,527 shares, respectively	839	853
Additional paid-in capital	791	791
Retained earnings	28,361	28,043
Total shareholders equity	31,921	31,602
Total liabilities and shareholders equity	$ 43,802	$ 46,149

NOTE: The condensed consolidated balance sheet at August 2, 2003 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

See notes to condensed consolidated financial statements

McRae Industries, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENT OF OPERATIONS
(In thousands, except share and per share data)
(Unaudited)

	Three Months Ended		Six Months Ended	
	January 31, 2004	**February 1, 2003**	**January 31, 2004**	**February 1, 2003**
Net revenues	$ 19,427	$ 17,611	$ 40,823	$ 37,408
Cost of revenues	15,190	13,368	31,485	28,430
Gross profit	4,237	4,243	9,338	8,978
Costs and expenses:				
Research & development	479	265	833	425
Selling, general and administrative	3,789	3,687	7,651	7,361
Other expense (income), net	(43)	(354)	(57)	(382)
Interest expense	34	44	71	93
Total costs and expenses	4,259	3,642	8,498	7,497
Earnings (loss) from operations before income taxes and minority interest	(22)	601	840	1,481
Provision for income taxes	(5)	232	297	574
Minority shareholder s interest in earnings of subsidiary	(3)	(3)	(5)	(4)
Net (loss) earnings	$ (14)	$ 372	$ 548	$ 911
Net earnings per common share	$ .00	$ .14	$ .20	$ .33
Weighted average number of common shares outstanding	2,768,499	2,768,499	2,768,499	2,768,499

See notes to condensed consolidated financial statements

McRae Industries, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENT OF CASH FLOWS
(In thousands)
(Unaudited)

	Six Months Ended January 31, 2004	Six Months Ended February 1, 2003
Net cash used in operating activities	$(1,251)	$ (1,241)
Cash flows from investing activities:		
Proceeds from sales of assets	5	375
Purchase of trade names and other assets		(150)
Capital expenditures	(349)	(234)
Net collections of long-term receivables	31	29
Net cash (used in) provided by investing activities	(313)	20
Cash flows from financing activities:		
Principal repayments of notes payable	(285)	(263)
Dividends paid	(230)	(226)
Net cash used in financing activities	(515)	(489)
Net decrease in cash and cash equivalents	(2,079)	(1,710)
Cash and cash equivalents at beginning of period	6,192	5,822
Cash and cash equivalents at end of period	$ 4,113	$ 4,112

NOTE: Non-cash operating and investing activities excluded from this statement of cash flows relate to the transfer of office equipment from inventory to property and equipment amounted to $719,000 and $648,000 for the first six months of fiscal 2004 and 2003, respectively.

See notes to condensed consolidated financial statements

McRae Industries, Inc. and Subsidiaries

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

NOTE A - BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared by the Company pursuant to the rules and regulation of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required by the accounting principals generally accepted in the United States for complete financial statements. In addition, all adjustments (consisting only of normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the six months ended January 31, 2004 are not necessarily indicative of the results that may be expected for the year ending July 31, 2004. The interim condensed consolidated financial information should be read in conjunction with the Company s August 2, 2003 audited consolidated financial statements and footnotes thereto included in the McRae Industries, Inc. Annual Report filed on Form 10-K with the SEC.

Certain reclassifications have been made to the prior year s financial statements to conform with the current year s presentation.

NOTE B - INVENTORIES

The components of inventory consist of the following (in thousands):

	January 31, 2004	August 2, 2003
Raw materials	$ 2,570	$ 3,293
Work-in-process	1,337	1,081
Finished goods	11,946	13,185
	$15,853	$17,559

NOTE C - SUBSEQUENT EVENTS

On March 1, 2004, the Company declared a cash dividend of $.06 cents per share on its Class A Common Stock payable on March 26, 2004, to shareholders of record on March 12, 2004.

NOTE D SUMMARY OF BUSINESS SEGMENTS

(In thousands)	Three Months Ended January 31, 2004	Three Months Ended February 1, 2003	Six Months Ended January 31, 2004	Six Months Ended February 1, 2003
Net revenues				
Bar Code	$ 2,655	$ 2,118	$ 4,911	$ 5,039
Office Products	4,531	4,501	9,904	9,342
Military Boots	7,421	4,712	15,742	9,910
Western/Work Boots	5,119	6,307	10,998	13,067
Eliminations/Other	(299)	(27)	(732)	50
	19,427	17,611	40,823	37,408
Net (loss) earnings from operations				
Bar Code	(358)	(496)	(721)	(714)
Office Products	(228)	(192)	(649)	(530)
Military Boots	592	702	2,076	1,531
Western/Work Boots	(178)	169	(165)	650
Eliminations/Other	150	418	299	544
	(22)	601	840	1,481
Provision for income taxes (benefit)	(5)	232	297	574
Minority shareholder s interest	(3)	(3)	(5)	(4)
Net (loss) earnings	$ (14)	$ 372	$ 548	$ 911

	January 31, 2004	August 2, 2003
Assets		
Bar Code	$ 4,694	$ 4,987
Office Products	11,862	13,074
Military Boots	6,962	6,328
Western/Work Boots	11,754	14,214
Eliminations/Other	8,530	7,546
	$43,802	$46,149

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the attached unaudited condensed consolidated financial statements and notes thereto, and with the Company s Annual Report on Form 10-K for the fiscal year ended August 2, 2003, including the financial information and management s discussion and analysis contained therein.

CRITICAL ACCOUNTING ESTIMATES

Our timely preparation of financial reports and related disclosures requires us to use estimates and assumptions that may cause actual results to be materially different from our estimated results. Specifically, we use estimates when accounting for depreciation, amortization, cost per copy contract contingencies, useful lives for intangible assets, and asset valuation allowances (including those for bad debts, inventory, and deferred income tax assets). Our most critical accounting estimates include the following:

Contract Contingencies

Our office products business leases equipment (usually for a sixty-month period) to county-wide education systems and sells the lease to third party leasing companies. Under this program the school system is billed on a monthly, quarterly or annual basis at a specified rate for each copy they make. The cost per copy charged to the school system is designed to cover the equipment cost, supplies (except for paper and staples), service, and a finance charge. On a quarterly basis, on a program-by-program basis, we project an expected outcome over the life of the program. We use historical copy usage to predict the number of copies to be made over the remaining life of the program. We adjust this estimate of the number of expected future copies based on known factors that will influence copy rates in each program. We use historical service and supply costs incurred on each program to estimate future service and supply costs on a per copy basis. We adjust these estimated costs for known factors that will impact service and supplies in the future. We also estimate any other costs expected to be incurred such as depreciation on rental equipment. On programs where the sum of the estimated future costs exceeds the expected future revenue, we recognize a provision for 100% of the expected losses for these programs.

Intangible Assets

We determine the utility of goodwill and trademarks based on estimated future cash flows and test for impairment in accordance with applicable accounting pronouncements. We estimate future cash flows based on historical performance and our knowledge of known factors likely to impact future cash flows.

Inventories

Inventories are recorded at the lower of cost or market value. We regularly review inventory quantities on hand and record a provision for excess and obsolete inventory based primarily on our estimated forecast and demand requirements for the next twelve months. Actual demand and market conditions may be different from those projected by our management.

Revenue Recognition

We recognize revenue under our current boot contract when the boots are inspected and accepted by the Government s Quality Assurance Representative (QAR), thereby transferring ownership to the Government. Pursuant to the contract, the boots become Government-owned property after inspection and acceptance by the QAR. The boots are transferred and stored in our warehouse, which is a designated storage facility approved by the Government, and accounted for as bill and hold sales in accordance with Securities and Exchange Commission Staff Accounting Bulletin No. 101, Revenue Recognition in Financial Statements.

Income Taxes

As part of the process of preparing our consolidated financial statements, we are required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves us estimating our actual current exposure together with assessing temporary differences resulting from differing treatment of items, such as leasing activity, allowances, and depreciation, for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are included within our consolidated balance sheet. We then assess the likelihood that our deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we establish a valuation allowance. To the extent we establish a valuation allowance or increase this allowance in a period, we include an expense within the tax provision in the statement of operations. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities, and any valuation allowance recorded against our net deferred tax assets. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we would establish an additional valuation allowance, which could materially impact our financial position and results of operations.

FINANCIAL CONDITION AND LIQUIDITY

Our cash and cash equivalents for the six months ended January 31, 2004, totaled approximately $4.1 million as compared to approximately $6.2 million at August 2, 2003. Working capital at the end of the first six months of fiscal 2004 amounted to $24.8 million, down slightly from $25.2 million at August 2, 2003.

Currently, we have two lines of credit with a bank totaling $4.75 million, all of which was available at January 31, 2004. One credit line totaling $1.75 million expires in June 2004. The $3.0 million credit line expires in November 2004. In January 2004, we obtained a $600,000 construction loan from a bank, all of which was available at January 31, 2004, to finance the expansion of our military boot facility. Principal and interest on this loan is due on July 11, 2004.

We believe that our current cash and cash equivalents, cash generated from operations, and available line of credit will be sufficient to meet our capital requirements for the remainder of fiscal 2004. Our contractual commitments for fiscal 2004 are approximately $833,000.

Selected cash flow data for the first six months of fiscal 2004 are presented below (in thousands):

	For the six months ended January 31, 2004
Source (Use) of Cash	
Operating activities:	
Net earnings adjusted for depreciation	$ 1,138
Accounts receivable	363
Inventories	1,706
Accounts payable	(1,787)
Income taxes	(1,085)
Net cash used in operating activities	(1,251)

Net cash used in operating activities for the first six months of fiscal 2004 totaled approximately $1.25 million as adjusted for non-cash transfers from inventory to rental equipment for the office products business. Net earnings adjusted for depreciation provided $1.1 million of cash. Trade accounts receivable provided $363,000 of cash primarily attributable to the timing of collection of accounts related to the heavier fall sales season and the decrease in second quarter demand for western boot products. This decrease in accounts receivable was partially offset by the timing of collection on increased military boot sales to the U.S. Government and bar code product sales in January. Inventory, net of transfers to rental equipment for the office products business, decreased by approximately $987,000 primarily the result of the planned reduction in the number of boot styles in the western boot business and the timing of inventory purchases to replace higher bar code product sales. This decrease in inventory was partially offset by higher material requirements for the military boot business and the timing of sales of office equipment to large county wide education and state government systems. The decrease in accounts payable used approximately $1.8 million of cash primarily attributable to the timing of payments for inventory related to heavy fourth quarter sales of office equipment to large county-wide school systems. Income tax payments for prior year s tax liability and current year s estimated tax payments used approximately $1.1 million of cash for the first six months of fiscal 2004.

Capital expenditures consisting primarily of production equipment for the military boot business totaled approximately $349,000. Rental equipment related to the office products business cost per copy program increased by approximately $719,000, all of which was transferred from inventory, for the first six months of fiscal 2004.

For the first six months of fiscal 2004, we used approximately $322,000 for principal and interest payments related to our long-term debt. Dividend payments amounted to approximately $230,000.

The increase in military boot sales to the U.S. Government may require substantial investment in raw materials, production equipment, and plant facilities. We will be required to invest approximately $1.0 million in manufacturing equipment and supplies to comply with the U.S. Government Contract requirements. (See discussion below under Military Boot Business).

Off-Balance Sheet Arrangements

As of January 31, 2004, we did not utilize any off-balance sheet financing arrangements and do not anticipate doing so in the future.

SECOND QUARTER FISCAL 2004 COMPARED TO SECOND QUARTER FISCAL 2003

Consolidated net revenues for the second quarter of fiscal 2004 totaled $19.4 million, a 10% increase over net revenues of $17.6 million for the second quarter of fiscal 2003. This increase in net revenues resulted primarily from significantly higher military boot requirements for the U.S. Government (the Government) and slight market improvement for bar code products. The increase in military boot and bar code product sales was partially offset by reduced demand for western and work boots.

Consolidated gross profit amounted to $4.2 million for the second quarters of both fiscal 2004 and 2003. As a percentage of net revenues, gross profit for the second quarter of fiscal 2004 w