

AMERICAN APPAREL, INC
Form 10-Q
August 17, 2010
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

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 No. 001-32697

American Apparel, Inc.

(Exact Name of Registrant as Specified in Its Charter)

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Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

20-3200601
(I.R.S. Employer
Identification No.)

747 Warehouse Street, Los Angeles, California
(Address of Principal Executive Offices)

90021
(Zip Code)

Registrant's Telephone Number, Including area code: (213) 488-0226

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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

Large accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

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

Common stock, \$0.0001 par value 71,447,445 shares outstanding on August 16, 2010.

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AMERICAN APPAREL, INC.

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Unless the context requires otherwise, all references in this report to the Company, Registrant, we, our, and us refer to American Apparel, Inc., a Delaware corporation, together with its wholly owned subsidiary, American Apparel (USA), LLC, and its other direct and indirect subsidiaries.

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q, including the documents incorporated by reference herein, contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. All statements in this Quarterly Report on Form 10-Q other than statements of historical fact are forward-looking statements for purposes of these provisions. Statements that include the use of terminology such as may, will, expects, believes, plans, estimates, potential, or continue, or the negative thereof or other and similar expressions are forward-looking statements. In addition, in some cases, you can identify forward-looking statements by words or phrases such as trend, potential, opportunity, believe, comfortable, expect, anticipate, current, intention, estimate, position, assume, outlook, maintain, sustain, seek, achieve, and similar expressions.

Any statements that refer to projections of our future financial performance, our anticipated growth and trends in our business, our goals, strategies, focuses and plans and other characterizations of future events or circumstances, including statements expressing general expectations or beliefs, whether positive or negative about future operating results or the development of our products and any statement of assumptions underlying any of the foregoing are forward-looking statements. Forward-looking statements in this report may include, without limitation, statements about:

future financial conditions and operating results;

our ability to remain in compliance with financial covenants under our financing arrangements;

our plan to make continued investments in advertising and marketing;

our growth, expansion and acquisition prospects and strategies, the success of such strategies and the benefits we believe can be derived from such strategies;

the outcome of litigation matters;

our intellectual property rights and those of others, including actual or potential competitors;

our personnel, consultants and collaborators;

operations outside the United States;

economic and political conditions;

overall industry and market performance;

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the impact of accounting pronouncements;

management's goals and plans for future operations; and

other assumptions described in this Quarterly Report on Form 10-Q underlying or relating to any forward-looking statements.

The forward-looking statements in this report speak only as of the date of this report and caution should be taken not to place undue reliance on any such forward-looking statements, which are qualified in their entirety by this cautionary statement. Forward-looking statements are subject to numerous assumptions, events, risks, uncertainties and other factors, including those that may be outside of our control and that change over time. As a result, actual results and/or the timing of events could differ materially from those expressed in or implied by the forward-looking statements and future results could differ materially from historical performance. Such assumptions, events, risks, uncertainties and other factors include, among others, those described in the Company's Annual Report on Form 10-K for the year ended December 31, 2009 (filed with the United States Securities and Exchange Commission (the "SEC") on March 31, 2010) and Amendments No. 1, No. 2 and No. 3 to the Company's Annual Report on form 10-K/A for the year ended December 31, 2009 (each filed with the SEC on April 29, 2010) as well as in other reports and documents we file with the SEC and include, without limitation, the following:

changes in the level of consumer spending or preferences or demand for our products;

disruptions in the global financial markets;

consequences of our significant indebtedness, including our relationships with our lenders and our ability to comply with our debt agreements and generate cash flow to service our debt;

our ability to regain compliance with the exchange rules of the NYSE Amex, LLC; the completion of the preparation and review of financial statements and related disclosures for the second quarter ended June 30, 2010, including any restatement, if applicable.

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the highly competitive and evolving nature of our business in the U.S. and internationally;

our ability to manage our growth and expansion both in the U.S. and internationally;

retailer consolidation and intensity of competition, both domestic and foreign, from other apparel providers;

technological changes in manufacturing, wholesaling, or retailing;

risks that the our suppliers and distributors may not timely produce or deliver our products;

loss or reduction in sales to our wholesale or retail customers or financial nonperformance by our wholesale customers;

the adoption of new accounting pronouncements or changes in interpretations of accounting principles;

changes in consumer spending patterns and overall levels of consumer spending;

the availability of store locations at appropriate terms and our ability to identify and negotiate new store locations effectively and to open new stores and expand internationally;

ability to attract customers to our stores;

seasonality and fluctuations in comparable store sales and margins;

our ability to successfully implement its strategic, operating and personnel initiatives;

our ability to maintain the value and image of our brand and protect our intellectual property rights;

changes in the cost of materials and labor;

location of our facilities in the same geographic area;

adverse changes in our credit ratings and any related impact on financing costs and structure;

risks associated with our foreign operations and foreign supply sources, such as disruption of markets, changes in import and export laws, currency restrictions and currency exchange rate fluctuations;

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continued compliance with U. S. and foreign government regulations, legislation and regulatory environments, including environmental, immigration, labor and occupational health and safety laws and regulations;

the risk that information technology systems changes may disrupt our supply chain or operations;

our ability to upgrade our information technology infrastructure and other risks associated with the systems that operate our online retail operations;

litigation and other inquiries and investigations, including the risk that we or our officers will not be successful in defending any proceedings, lawsuits, disputes, claims or audits;

ability to effectively manage inventory and inventory reserves;

changes in key personnel, our ability to hire and retain key personnel, and our relationship with our employees;

material weaknesses in internal controls;

costs as a result of operating as a public company; and

general economic conditions, including increases in interest rates, geopolitical events, other regulatory changes and inflation deflation.

All forward-looking statements included in this document are made as of the date hereof, based on information available to us as of the date hereof, and we assume no obligation to update any forward-looking statements.

Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****American Apparel, Inc. and Subsidiaries****Condensed Consolidated Balance Sheets****(Amounts in thousands, except par value)**

	March 31, 2010 (unaudited)	December 31, 2009 *
ASSETS		
CURRENT ASSETS		
Cash	\$ 6,461	\$ 9,046
Trade accounts receivable, net of allowances of \$1,833 and \$1,763 at March 31, 2010 and December 31, 2009, respectively	19,097	16,907
Prepaid expenses and other current assets	5,632	9,994
Income taxes receivable	4,750	4,494
Inventories, net	138,397	141,235
Deferred income taxes	1,000	4,627
Total current assets	175,337	186,303
PROPERTY AND EQUIPMENT, net	94,945	103,310
DEFERRED INCOME TAXES		12,033
OTHER ASSETS, net	25,459	25,933
TOTAL ASSETS	\$ 295,741	\$ 327,579
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES		
Cash overdraft	\$ 386	\$ 3,741
Revolving credit facilities and current portion of long-term debt, net of unamortized discount of \$19,451 at March 31, 2010	83,884	6,346
Accounts payable	20,915	19,705
Accrued expenses	34,217	30,573
Income taxes payable	950	2,608
Current portion of capital lease obligations	1,461	1,907
Total current liabilities	141,813	64,880
LONG-TERM DEBT, net of unamortized discount of \$20,537 at December 31, 2009	406	65,997
SUBORDINATED NOTES PAYABLE TO RELATED PARTY	4,434	4,355
CAPITAL LEASE OBLIGATIONS, net of current portion	868	1,020
DEFERRED RENT	22,841	22,052
OTHER LONG-TERM LIABILITIES	10,036	11,934
TOTAL LIABILITIES	180,398	170,238
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS EQUITY		
Preferred stock, \$0.0001 par value, authorized 1,000 shares; none issued		

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Common stock, \$0.0001 par value, authorized 120,000 shares; 72,881 shares issued and 71,447 shares outstanding at March 31, 2010 and 72,467 shares issued and 71,033 shares outstanding at December 31, 2009

	7	7
Additional paid-in capital	151,675	150,449
Accumulated other comprehensive loss	(2,464)	(2,083)
(Accumulated deficit) retained earnings	(23,831)	19,012
Less: Treasury stock, 1,434 shares at cost	(10,044)	(10,044)
TOTAL STOCKHOLDERS EQUITY	115,343	157,341
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 295,741	\$ 327,579

* Condensed from audited financial statements

See accompanying notes to condensed consolidated financial statements.

Table of Contents**American Apparel, Inc. and Subsidiaries****Condensed Consolidated Statements of Operations****(Amounts in thousands, except per share amounts)****(unaudited)**

	Three Months Ended March 31,	
	2010	2009
Net sales	\$ 121,814	\$ 114,284
Cost of goods sold	60,473	48,887
Gross profit	61,341	65,397
Selling expenses	52,597	45,343
General and administrative expenses (including related party charges of \$225 and \$198 for the three months ended March 31, 2010 and March 31, 2009, respectively)	26,109	23,597
Retail store impairment charges	4,191	356
Loss from operations	(21,556)	(3,899)
Interest expense (including related party interest expense of \$65 and \$75 for the three months ended March 31, 2010 and March 31, 2009, respectively)	5,046	7,637
Foreign currency transaction loss	756	1,930
Other expense (income)	155	(55)
Loss before income tax	(27,513)	(13,411)
Income tax expense (benefit) (including valuation allowance charges of \$15,493 recorded at March 31, 2010)	15,329	(2,852)
Net loss	\$ (42,842)	\$ (10,559)
Basic and diluted loss per share	\$ (0.60)	\$ (0.15)
Weighted average basic and diluted shares outstanding	71,273	71,003

See accompanying notes to condensed consolidated financial statements.

Table of Contents**American Apparel, Inc. and Subsidiaries****Condensed Consolidated Statements of Cash Flows**

(Amounts in thousands)

(unaudited)

	Three Months Ended March 31,	
	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES		
Cash received from customers	\$ 118,979	\$ 116,739
Cash paid to suppliers, employees and others	(119,421)	(113,889)
Income taxes paid	(707)	(2,775)
Interest paid	(3,541)	(3,905)
Other	(145)	224
Net cash used in operating activities	(4,835)	(3,606)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(2,941)	(7,502)
CASH FLOWS FROM FINANCING ACTIVITIES		
Cash overdraft from financial institution	(3,351)	(554)
Borrowings (repayments) under revolving credit facilities, net	10,761	(11,188)
Repurchase of common stock for payment of payroll tax withholding on stock-based compensation	(592)	
Deferred financing costs paid		(4,454)
Proceeds of notes payable to related party		4,000
Repayment of notes payable to related party		(3,250)
Proceeds from issuance of long-term debt, net of \$5,000 discount for the three months ended March 31, 2009		75,000
Repayment of long-term debt	(39)	(51,042)
Repayment of capital lease obligations	(557)	(620)
Net cash provided by financing activities	6,222	7,892
EFFECT OF FOREIGN EXCHANGE RATE CHANGES ON CASH	(1,031)	(1,164)
NET DECREASE IN CASH	(2,585)	(4,380)
CASH, beginning of period	9,046	11,368
CASH, end of period	\$ 6,461	\$ 6,988
RECONCILIATION OF NET LOSS TO NET CASH USED IN OPERATING ACTIVITIES		
Net loss	\$ (42,842)	\$ (10,559)
Depreciation and amortization of property and equipment and other assets	7,116	6,407
Amortization of debt discount and deferred financing costs	1,453	3,733
Foreign currency transaction loss	756	1,930
Accrued interest paid-in-kind	51	
Stock-based compensation expense	1,763	525
Retail store impairment charges	4,191	356
Deferred income taxes	17,081	396
Loss on disposal of property and equipment	10	31
Bad debt expense	290	104

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Deferred rent	982	1,641
Changes in cash due to changes in operating assets and liabilities:		
Trade accounts receivables	(3,125)	2,463
Inventories	2,682	(342)
Prepaid expenses and other current assets	4,285	661
Other assets	(428)	(1,101)
Accounts payable	1,471	(7,331)
Accrued expenses and other long-term liabilities	1,888	3,486
Income taxes receivable/payable	(2,459)	(6,006)
Net cash used in operating activities	\$ (4,835)	\$ (3,606)

NON-CASH OPERATING, INVESTING AND FINANCING ACTIVITIES

Property and equipment acquired and included in accounts payable	\$ 379	\$ 1,722
Issuance of warrants in connection with debt financing at relative fair value		\$ 18,672

See accompanying notes to condensed consolidated financial statements.

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American Apparel, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements

For the Three Months Ended March 31, 2010 and 2009

(Amounts and shares in thousands, except per share amounts)

(unaudited)

Note 1. Organization and Business

American Apparel, Inc. and its subsidiaries (collectively the Company) is a vertically-integrated manufacturer, distributor, and retailer of branded fashion basic apparel. The Company sells its products through a wholesale distribution channel supplying t-shirts and other casual wear to distributors and screen printers, as well as directly to customers through its retail stores located in the United States and internationally. In addition, the Company operates an online retail e-commerce website. At March 31, 2010, the Company operated a total of 280 retail stores in the United States, Canada and 18 other countries.

Going Concern, Liquidity and Management's Plan

As of March 31, 2010, the Company had approximately \$6,461 in cash, \$35,601 of availability for additional borrowings and \$11,127 outstanding on a \$75,000 revolving credit facility under the Bank of America Credit Agreement (BofA Credit Agreement), \$3,941 of availability for additional borrowings and \$6,012 outstanding on a C\$11,000 revolving credit facility under the Bank of Montreal Credit Agreement, and \$66,679 of term loans outstanding under the Lion Credit Agreement (see Notes 7 and 8). As of March 31, 2010, the Company was in compliance with all required covenants of the BofA Credit Agreement, the Bank of Montreal Agreement and the Lion Credit Agreement.

The Company incurred a substantial loss from operations and had negative cash flows from operating activities for the three months ended March 31, 2010. Based upon results of operations for the three months ended March 31, 2010 and trends occurring in the Company's business since the first quarter and through the issuance date of these financial statements and projected for the remainder of 2010, the Company may not have sufficient liquidity necessary to sustain operations for the next twelve months. Also, the Company's current operating plan indicates that losses from operations are expected to continue through at least the third quarter of 2010. The Company also believes that it is probable that as of September 30, 2010 the Company will not be in compliance with the minimum Consolidated EBITDA covenant under the Lion Credit Agreement. Based upon the foregoing, the Company has classified its obligations outstanding under the Lion Credit Agreement as current liabilities in the accompanying condensed consolidated balance sheets as of March 31, 2010.

Noncompliance with covenants under the Lion Credit Agreement constitutes an event of default under the BofA Credit Agreement, which, if not waived, could block the Company from making borrowings under the BofA Credit Agreement. In addition, all indebtedness under the BofA Credit Agreement and the Lion Credit Agreement could be declared immediately due and payable. The Company anticipates working with its lenders to obtain amendments prior to any possible covenant noncompliance; however, the Company cannot provide assurance that it will be able to secure such amendments. If such indebtedness is declared due and immediately payable or the Company cannot borrow under the BofA Credit Agreement, the Company would have to obtain alternative sources of liquidity; however, the Company cannot provide assurance that it will be able to obtain such alternative sources of liquidity and/or modify its operations to maintain liquidity on terms that are acceptable to the Company, or at all. These factors, among others, raise substantial doubt that the Company will be able to continue as a going concern.

Management continues to develop a plan intended to improve the operating performance and the financial position of the Company. This plan includes moderating production at the Company's manufacturing facilities to reduce inventory levels, and reduce raw material purchases and labor; a streamlining of the Company's logistics operations; the potential subleasing of certain of the Company's leased properties used in the Company's manufacturing operations; merchandise price rationalization in the Company's wholesale and retail channels; a strategic review of the Company's retail real estate portfolio, including potential lease renegotiations and store closures; improved merchandise allocation procedures; a review of staffing levels at the Company's retail locations and the selective and targeted reduction in the Company's marketing spend. In addition, the Company continues to develop other initiatives intended to either increase sales, reduce costs or improve liquidity. However, there can be no assurance that management's plan to improve the operating performance and the financial position of the Company will be successful.

The accompanying condensed consolidated financial statements do not include any adjustments to reflect the possible future effects on the recoverability of assets or the amounts of liabilities that may result should the Company be unable to continue as a going concern.

Note 2. Principles of Consolidation and Basis of Presentation

The condensed consolidated financial statements include the accounts of American Apparel, Inc. and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated upon consolidation.

The accompanying unaudited condensed consolidated financial statements of the Company and its wholly owned subsidiaries have been prepared by the Company, in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and are presented in accordance with the requirements of Form 10-Q and Rule 10-01 of Regulation S-X,

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American Apparel, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Continued)

For the Three Months Ended March 31, 2010 and 2009

(Amounts and shares in thousands, except per share amounts)

(unaudited)

and have not been audited. Accordingly, these unaudited condensed consolidated financial statements do not include all of the information and notes required by GAAP for complete financial statements and should be read in conjunction with the consolidated financial statements and notes thereto for the fiscal year ended December 31, 2009 included in the Company's Annual Report on Form 10-K. In the opinion of management, the interim unaudited condensed consolidated financial statements included herein contain all adjustments, including normal recurring adjustments, considered necessary to present fairly the Company's financial position, the results of operations and cash flows for the periods presented.

The operating results and cash flows of the interim periods presented herein are not necessarily indicative of the results to be expected for any other interim period or the full year.

Note 3. Summary of Significant Accounting Policies and Other Disclosures

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Management bases its estimates on historical experience and on various assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The most significant estimates include: revenue recognition; sales returns and other allowances; allowance for doubtful accounts; inventory valuation and obsolescence; valuation and recoverability of long-lived assets, including the values assigned to acquired intangible assets and goodwill, and property and equipment; contingencies, including accruals for the outcome of current litigation and self-insurance liabilities; income taxes, including uncertain tax positions and recoverability of deferred income taxes; and foreign currency.

On a regular basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results could differ from those estimates.

Earnings Per Share

The Company presents earnings (loss) per share (EPS) in accordance with Accounting Standards Codification ASC 260 Earnings per Share (ASC 260). ASC 260 requires dual presentation of basic and diluted EPS. Basic EPS includes no dilution and is computed by dividing net loss available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS includes the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock.

The Company's net loss for the periods presented in the accompanying condensed consolidated statement of operations is available to the common stockholders. For the three months ended March 31, 2010 and 2009, the Company had 1,000 shares of common stock underlying the SOF Warrant (as defined in Note 13) and 16,000 shares of common stock underlying the Lion Warrant (as defined in Note 13) in which their weighted average affects were excluded from the calculation of net loss per share because their impact would have been anti-dilutive.

Comprehensive Loss

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In accordance with ASC 220 - Comprehensive Income, the Company is required to display comprehensive income (loss) and its components as part of its complete set of financial statements. Comprehensive income represents the change in stockholders' equity resulting from transactions other than stockholder investments and distributions. Included in accumulated other comprehensive income (loss) are changes in equity that are excluded from the Company's net loss, specifically, unrealized gains and losses on foreign currency translation adjustments.

A reconciliation of comprehensive loss for the three months ended March 31, 2010 and 2009 is as follows:

	2010	2009
Net loss, as reported	\$ (42,842)	\$ (10,559)
Foreign currency translation adjustments	(380)	(2,106)
Comprehensive loss	\$ (43,222)	\$ (12,665)

Concentration of Credit Risk

Financial instruments which potentially subject the Company to credit risk consist primarily of cash (the amounts of which may, at times, exceed Federal Deposit Insurance Corporation limits on insurable amounts) and trade accounts receivable, relating substantially to the Company's U.S. wholesale segment. The Company mitigates its risk related to cash by investing in or through major financial institutions. The Company had approximately \$5,797 and \$7,500 held in foreign banks at March 31, 2010, and December 31, 2009, respectively.

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American Apparel, Inc. and Subsidiaries

Notes to Condensed Consolidated Financial Statements (Continued)

For the Three Months Ended March 31, 2010 and 2009

(Amounts and shares in thousands, except per share amounts)

(unaudited)

The Company mitigates its risk related to trade accounts receivable by performing on-going credit evaluations of its customers and adjusting credit limits based upon payment history and the customer's current credit worthiness, as determined by a review of their current credit information. The Company also maintains an insurance policy for certain customers based on their credit rating and established limits. Collections and payments from customers are continuously monitored. As of March 31, 2010, three customers accounted for 35% of the Company's total trade accounts receivables and 45% of the U.S. Wholesale segment's trade accounts receivables. The Company maintains an allowance for doubtful accounts, which is based upon historical experience and specific customer collection issues that have been identified. While bad debt expenses have historically been within expectations and allowances established, the Company cannot guarantee that it will continue to experience the same credit loss rates that it has in the past.

Foreign Currency Forward Exchange Contracts

The Company follows the provisions of ASC 820 – Fair Value Measurements and Disclosures (formerly, SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities), as amended, which require the recognition of derivative instruments in the balance sheet as either an asset or liability measured at its fair value. Changes in the fair value of derivatives are to be recorded each period in comprehensive income, if the derivative is designated and effective as part of a hedge accounting transaction, or in earnings if the derivative does not qualify for hedge accounting. The Company's foreign currency forward exchange contracts do not qualify for hedge accounting and, accordingly, adjustments to fair value are recorded in foreign currency transaction loss in the condensed consolidated statements of operations.

The Company enters into forward contracts to mitigate the cash and income statement impact of fluctuations in foreign currencies. At March 31, 2010, the Company held forward exchange contracts to purchase an aggregate notional amount of \$1,800, to hedge forecasted purchases of inventory in U.S. dollars through December 31, 2010. At March 31, 2010, the fair value of the forward contracts, based on quoted market rates (level 2 within the fair value hierarchy) resulted in an unrealized loss of C\$68, and is included in accrued expenses in the accompanying condensed consolidated balance sheets. During the three months ended March 31, 2010 and 2009, losses of C\$68 and gains of C\$103, respectively, related to the forward contracts held were included in foreign currency transaction loss in the accompanying condensed consolidated statements of operations. As of December 31, 2009, the Company did not hold any forward contracts.

Income Taxes

The Company recognizes deferred tax liabilities and assets for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The Company estimates the degree to which tax assets and credit carryforwards will result in a benefit based on expected profitability by tax jurisdiction. A valuation allowance for such tax assets and loss carryforwards is provided when it is determined that such assets will more likely than not go unrealized. If it becomes more likely than not that a tax asset will be realized, the related valuation allowance on such assets would be reversed.

Management makes judgments as to the interpretation of the tax laws that might be challenged upon an audit and cause changes to previous estimates of tax liability. In addition, the Company operates within multiple taxing jurisdictions and is subject to audit in these jurisdictions. In management's opinion, adequate provisions for income taxes have been made for all years. If actual taxable income by tax jurisdiction varies from estimates, additional allowances or reversals of reserves may be necessary.

The Company's foreign domiciled subsidiaries are subject to foreign income taxes on earnings in their respective jurisdictions. The Company elected to have their foreign subsidiaries, except for its subsidiaries in Brazil, Canada, China, Spain, Italy and Ireland, consolidated in the Company's U.S. federal income tax return; the Company will generally be eligible to receive tax credits on its U.S. federal income tax return for most of the foreign taxes paid.

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The Company accounts for uncertain tax positions according to ASC 740 Income Taxes . Gross unrecognized tax benefits at March 31, 2010 and December 31, 2009 are included in other long-term liabilities in the accompanying condensed consolidated balance sheets. The Company accrues interest and penalties, if incurred, on unrecognized tax benefits as a component of the income tax expense (benefit) in the accompanying condensed consolidated statements of operations.

Accounting Standards Updates

In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update ASU No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) - Improving Disclosures about Fair Value Measurements. ASU No. 2010-06 requires new disclosures and clarifies certain existing disclosure requirements about fair value measurement as set forth in ASC 820.

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ASU No. 2010-06 amends ASC 820 to require reporting entities to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers. ASU No. 2010-06 also amends ASC 820 to require reporting entities to present separately information about purchases, sales, issuances, and settlements in the reconciliation for fair value measurements when significant unobservable inputs are used. In addition, ASU No. 2010-06 clarifies the requirements of certain existing disclosures. ASU No. 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009, except for disclosures about purchases, sales, issuances, and settlements in the roll forward of activity in Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The adoption of ASU No 2010-06 did not have a material impact on the Company's results of operations or financial position.

Note 4. Inventories

The components of inventories are as follows:

	March 31, 2010	December 31, 2009
Raw materials	\$ 20,167	\$ 19,506
Work in process	952	1,475
Finished goods	121,644	123,874
	142,763	144,855
Less reserve for inventory shrinkage and obsolescence	(4,366)	(3,620)
Total, net of reserves	\$ 138,397	\$ 141,235

Note 5. Property and Equipment

The components of property and equipment are as follows:

	March 31, 2010	December 31, 2009
Machinery and equipment	\$ 41,654	\$ 41,231
Furniture and fixtures	34,972	34,356
Computers and software	25,025	24,627
Automobiles and light trucks	1,163	1,221
Leasehold improvements	84,064	82,565
Buildings	574	557
Construction in progress	2,218	1,933

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	189,670	186,490
Less accumulated depreciation and amortization	(94,725)	(83,180)
Total	\$ 94,945	\$ 103,310

Property and equipment is recorded on the basis of cost and depreciated over the estimated used useful lives of fixed assets. The useful lives of the Company's major classes of assets are as follows:

Machinery and equipment	5 to 7 years
Furniture and fixtures	3 to 5 years
Computers and software	3 to 5 years
Automobiles and light trucks	3 to 5 years
Leasehold improvements	Shorter of lease term or useful life
Buildings	25 years

Depreciation and amortization expense relating to property and equipment (including capitalized leases) is recorded in cost of sales and operating expenses in the condensed consolidated statements of operations and was \$7,116 and \$6,407 for the three months ended March 31, 2010 and 2009, respectively.

The Company identified indicators of impairment present at certain retail stores with its U.S. Retail and International segments. Accordingly, the Company performed a recoverability test and an impairment test on these stores and determined, based on the results of an undiscounted cash flow and discounted cash flow analysis (level 3 in the fair value hierarchy), respectively, that the fair value of the assets at nineteen retail stores was less than their carrying value at March 31, 2010 as evaluated based upon sales performance through the date of issuance of these financial statements, and projected future cash flows over the lengths of their respective leases at these locations. The Company recorded an impairment charge relating primarily to certain retail store leasehold improvements in the U.S. Retail, Canadian

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and International segments of \$4,191 and \$356 for the three months ended March 31, 2010 and 2009, respectively, as a component of retail store impairment charges in the accompanying condensed consolidated statements of operations to reduce the assets carrying value to their estimated fair value.

Note 6. Accrued Expenses

The components of accrued expenses are as follows:

	March 31, 2010	December 31, 2009
Accrued compensation, bonuses and related taxes	\$ 10,307	\$ 7,604
Workers' compensation and other self-insurance reserves	3,392	4,807
Sales tax, value added tax, property taxes	1,681	2,603
Gift cards and store credits	3,936	4,387
ICE inspection-related workers' compensation claims (see Note 14 and Note 15)	1,890	
Other	13,011	11,172
	\$ 34,217	\$ 30,573

7. Revolving Credit Facilities and Current Portion of Long-Term Debt

Revolving credit facilities and current portion of long-term debt consists of the following:

	March 31, 2010	December 31, 2009
Revolving credit facility, maturing July 2012 (a)	\$ 11,127	\$ 6,249
Revolving credit facility, due on demand (b)	6,012	
Current portion of long-term debt	66,745	97
Total revolving credit facilities and current portion of long-term debt	\$ 83,884	\$ 6,346

The Company incurred interest charges of \$5,046 and \$7,637 for the three months ended March 31, 2010 and 2009, respectively, for all outstanding borrowings.

(a)

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The Company has a revolving credit facility of \$75,000 with Bank of America, N.A. (BofA and the BofA Credit Agreement), subject to certain advance restrictions based on eligible inventory and accounts receivable. The BofA Credit Agreement expires on July 12, 2012.

Borrowings under the BofA Credit Agreement are subject to certain advance provisions established by the BofA and are collateralized by substantially all of the Company's assets.

Interest under the BofA Credit agreement is at the London Interbank Offered Rate (LIBOR) (0.23% at March 31, 2010) plus 4.5% or BofA's prime rate (which rate can in no event be lower than LIBOR plus 4.5% per annum and was 3.25% at March 31, 2010) plus 2.5%, at the Company's option. At March 31, 2010 and December 31, 2009, the Company had \$9,370 and \$9,381, respectively, of outstanding letters of credit secured against the BofA Credit Agreement. Available borrowing capacity at March 31, 2010 and December 31, 2009 was \$35,601 and \$41,200, respectively.

Significant covenants included in the BofA Credit Agreement, as amended, include limiting the Company's capital expenditures for the combined U.S. Wholesale and U.S. Retail segments to \$25,000 for fiscal 2010. The Company's actual capital expenditures for the combined U.S. Wholesale and U.S. Retail segments were \$2,279 for the quarter ended March 31, 2010.

BofA Credit Agreement also imposes a minimum excess availability covenant which requires the Company to maintain minimum excess availability of 10% of the Company's net availability under the BofA Credit Agreement.

Among other provisions, the BofA Credit Agreement contains certain subjective acceleration clauses and requires that the Company maintain an arrangement similar to a traditional lockbox, and is therefore classified as a current liability in the condensed consolidated balance sheets.

The Company was in compliance with all required covenants of the BofA Credit Agreement at March 31, 2010.

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- (b) Wholly owned subsidiaries of the Company, American Apparel Canada Wholesale Inc. and American Apparel Canada Retail Inc. (collectively, the CI Companies), have a line of credit with Bank of Montreal that provided for borrowings up to C\$11,000 due on demand with a fixed maturity date of December 30, 2012, bearing interest at the bank's prime rate (2.5% at March 31, 2010) plus 2.00% per annum payable monthly. This line of credit is secured by moveable hypothecs, which provide for a charge on the CI Companies' accounts receivable, inventory and certain other moveable assets and by certain sections of the Bank Act of Canada on inventory. Available borrowing capacity at March 31, 2010 and December 31, 2009 was C\$4,017 and C\$11,000, respectively.

The credit agreement contains various covenants which require the CI Companies to maintain certain financial ratios and commitments as defined by the agreement. CI Companies were in compliance with all required covenants at March 31, 2010. However, as of June 30, 2010, CI Companies were not in compliance with the covenant which required furnishing audited financial statements to Bank of Montreal within 120 days after December 31, 2009.

Note 8. Long-Term Debt

Long-term debt consists of the following:

	March 31, 2010	December 31, 2009
Long-term debt with Lion, including accrued interest paid-in-kind of \$6,130 and net of discount of \$19,451 and \$20,537 at March 31, 2010 and December 31, 2009, respectively (a)	\$ 66,679	\$ 65,593
Other	472	501
Total long-term debt	67,151	66,094
Current portion of long-term debt (b)	(66,745)	(97)
Long-term debt, net of current portion	\$ 406	\$ 65,997

- (a) As of December 31, 2008, the Company had a term loan agreement with SOF in the amount of \$51,000. Indebtedness under the SOF Credit Agreement bore interest at 16% per annum, payable monthly and was to mature on April 20, 2009. The SOF loan was fully repaid on March 13, 2009 from the proceeds of a term loan with Lion. As a result of the early extinguishment of the SOF term loan, the Company wrote-off \$1,112 of unamortized deferred financing costs, which was included as a component of interest expense in the condensed consolidated statement of operations.

In connection with the Ninth Amendment of the SOF Credit Agreement in December 2008, the Company paid SOF a fee of \$2,550 and issued to SOF a warrant (the SOF Warrant) to purchase 1,000 shares of Company common stock at an exercise price of \$3.00 per share (see Note 13).

On March 13, 2009, the Company entered into the Lion Credit Agreement. Pursuant to the Lion Credit Agreement, Lion made term loans to the Company in an aggregate principal amount equal to \$80,000, of which \$5,000 of such loans constituted a fee paid by the Company to Lion in connection with the Lion Credit Agreement. The term loans under the Lion Credit Agreement mature on December 31, 2013 and bear interest at a rate of 15% per annum, payable quarterly in arrears. At the Company's option, accrued interest may be paid (i) entirely in cash, (ii) paid half in

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cash and half in kind, or (iii) entirely in kind. The Company's obligations under the Lion Credit Agreement are secured by a second lien on substantially all of the assets of the Company. The Lion Credit Agreement is subordinated to the BofA Credit Agreement and contains customary representations and warranties, events of default, affirmative covenants and negative covenants (which impose restrictions and limitations on, among other things, dividends, investments, asset sales, capital expenditures and the ability of the Company to incur additional debt and liens) and a total leverage ratio financial maintenance covenant. The Company is permitted to prepay the loans in whole or in part at any time at its option, with no prepayment penalty.

Approximately \$51,294 of the proceeds of the loans made under the Lion Credit Agreement was used by the Company to repay in full all outstanding principal and interest due under the SOF Credit Agreement. The remaining proceeds were used to repay \$3,250 of loans owed by the Company to its CEO (see Note 10), to pay fees and expenses related to the transaction of \$4,276 which were capitalized as deferred financing costs and included in other assets in the accompanying condensed consolidated balance sheets, and to reduce the outstanding revolver balance under the BofA Credit Agreement by \$15,974.

In connection with the loans under the Lion Credit Agreement, the Company issued the Lion Warrant (as defined in Note 13). The Company allocated the cash received from the Lion Credit Agreement between debt and warrants based on their relative fair values. The relative fair value of the debt under the Lion Credit Agreement was approximately \$56,328, based on a net present value of future cash flows using a discount rate of 21.6% determined by comparable financial instruments. The Lion Warrant was recorded as a debt discount and a credit to stockholders' equity at its relative fair value of approximately \$18,672. At March 31, 2010, the debt, net of unamortized discount and excluding interest paid-in-kind of \$6,130, totaled \$60,549 and will be accreted up to the \$80,000 par value of the loan using the effective interest method over the term of the Lion Credit Agreement. The Lion Warrant may be exercised by Lion by paying the exercise price in cash, pursuant to "cashless exercise" of

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the warrant or by a combination of the two methods. The Lion Warrant contains certain anti-dilution protections in favor of Lion providing for proportional adjustment of the warrant price and, under certain circumstances, the number of shares of the Company's common stock issuable upon exercise of the Lion Warrant, in connection with, among other things, stock dividends, subdivisions and combinations and the issuance of additional equity securities of the Company at less than fair market value.

Significant covenants in the Lion Credit Agreement include limiting the Company's capital expenditures to \$27,500 for fiscal 2010. The Company's actual capital expenditures were \$2,941 for the quarter ended March 31, 2010. The Lion Credit Agreement also contains a Total Debt to Consolidated EBITDA ratio covenant (as further described in the Lion Credit Agreement) which must be maintained at a level of no more than 1.75:1.00 for the four quarter period ending March 31, 2010 and 1.70:1.00 for the four quarter period ending June 30, 2010.

- (b) On March 31, 2010, the Company entered into a second amendment to the Lion Capital Agreement, which among other things, increased the maximum permitted ratio Total Debt to Consolidated EBITDA (as defined in the Lion Credit Agreement) for the four quarter period ending March 31, 2010 from 1.75:1.00 to 2.00:1.00 and for the four quarter period ending June 30, 2010 from 1.70:1.00 to 1.90:1.00. On June 23, 2010, the Company entered into a third amendment to the Lion Capital Agreement, which among other things, (i) replaced the Total Debt to Consolidated EBITDA financial covenant with a minimum Consolidated EBITDA financial covenant, tested on a quarterly basis, and (ii) increased the interest rate payable under the Lion Credit Agreement from 15% to 17% per annum (x) for the period from June 21, 2010 through the date that the Company delivers financial statements to Lion for the three months ended September 30, 2010, and (y) thereafter from the time financial statements for any Fiscal Quarters (as defined in the Lion Credit Agreement) demonstrate that the ratio of Total Debt to Consolidated EBITDA as at the end of such Fiscal Quarter exceeds certain specified ratios until the Company delivers financial statements to Lion for the next Fiscal Quarter.

The Company was in compliance with the covenants under the Lion Credit Agreement on March 31, 2010. However, the Company has determined, based on its operating plan for the remainder of 2010, that it is probable that as of September 30, 2010, the Company will not be in compliance with the minimum Consolidated EBITDA covenant under the Lion Credit Agreement. The Company anticipates working with its lenders to obtain amendments prior to any possible covenant noncompliance; however, the Company can provide no assurance that it will be able to secure such amendments to the covenants. Noncompliance with covenants under the Lion Credit Agreement constitutes an event of default under the BofA Credit Agreement, which, if not waived, could block the Company from making borrowings under the BofA Credit Agreement. In addition, all indebtedness under the BofA Credit Agreement and the Lion Credit Agreement could be declared immediately due and payable. The Company anticipates working with its lenders to obtain amendments prior to any possible covenant noncompliance; however, the Company cannot provide assurance that it will be able to secure such amendments. If such indebtedness is declared due and immediately payable or the Company cannot borrow under the BofA Credit Agreement, the Company would have to obtain alternative sources of liquidity; however, the Company cannot provide assurance that it will be able to obtain such alternative sources of liquidity and/or modify its operations to maintain liquidity on terms that are acceptable to the Company, or at all. These factors, among others, raise substantial doubt that the Company will be able to continue as a going concern. Based upon the foregoing, the Company has classified its obligations outstanding under the Lion Credit Agreement as current liabilities in the accompanying condensed consolidated balance sheets as of March 31, 2010.

Note 9. Fair Value of Financial Instruments

The carrying amount reported in the condensed consolidated balance sheets for cash, accounts receivable (including credit card receivables), accounts payable and accrued expenses approximates fair value because of the short-term maturity of those instruments. The carrying amount for borrowings under the revolving credit facility with BofA approximates fair value because of the variable market interest rate charged to the Company for these borrowings. The fair value of the term loans with Lion was estimated using a discounted cash flow analysis and a yield rate that was estimated using yield rates for publicly traded debt instruments of comparable companies with similar features. It was not practicable to

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estimate the fair value of notes payable to related parties.

The carrying amounts and fair values of the Company's financial instruments are presented below as of March 31, 2010:

	Carrying Amount	Fair Value
Current portion of long-term debt, net of discount of \$19,451 and including interest paid-in-kind of \$6,130 (level 3)	\$ 66,679	\$ 77,873

Non-financial assets recorded at fair value on a non-recurring basis, relating to property and equipment, are discussed in Note 5.

Note 10. Subordinated Notes Payable to Related Party

At March 31, 2010 and December 31, 2009, the Company had outstanding loans payable to its CEO of \$4,434 and \$4,355, respectively. These loans bear interest at 6% and are due at various dates between December 2012 and January 2013. On February 10, 2009, the CEO of the Company loaned the Company an additional \$4,000 in exchange for a promissory note. In connection with the

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Lion Credit Agreement entered into during March 2009, the Company repaid \$3,250 of the outstanding loans payable to its CEO. For the three months ended March 31, 2010 and 2009, interest expense related to these loans were \$65 and \$75 (including interest paid-in-kind), respectively.

Note 11. Income Taxes

Income taxes for the quarter ended March 31, 2010 were computed using the effective tax rate estimated to be applicable for the full fiscal year, which is subject to ongoing review and evaluation by management. In accordance with ASC 740, *Income Taxes*, the Company evaluates whether a valuation allowance should be established against the net deferred tax assets based upon the consideration of all available evidence and using a more likely than not standard. Significant weight is given to evidence that can be objectively verified. The determination to record a valuation allowance is based on the recent history of cumulative losses and losses expected in the near future. In conducting the analysis, the Company utilizes an approach which considers the current year loss, including an assessment of the degree to which any losses are driven by items that are unusual in nature and incurred to improve future profitability. In addition, the Company reviews changes in near-term market conditions and any other factors arising during the period which may impact our future operating results. Finally, the Company's ability to continue as a going concern was also considered as evidence in the assessment of the need to establish a valuation allowance against the net deferred tax assets.

The Company incurred a substantial loss from operations for the three months ended March 31, 2010. Based upon results of operations for the three months ended March 31, 2010 and trends occurring in the Company's business after the first quarter and through the issuance date of these financial statements and projected for the remainder of 2010, the current operating plan indicates that losses from operations are expected to continue through at least the third quarter of 2010. Because continuing losses before income taxes incurred by the Company make it more likely than not that the Company will not realize any benefit from the deferred tax assets recorded by the Company in previous periods, the Company will not record income tax benefits in the condensed consolidated financial statements until it is determined that it is more likely than not that the Company will generate sufficient taxable income in the respective jurisdictions to realize the deferred income tax assets in the respective jurisdictions. As a result of the analysis, the Company determined that a full valuation allowance against the net deferred tax assets on a jurisdictional basis in the first quarter of fiscal 2010 was required and recorded a valuation allowance of \$15,493 against its deferred tax assets as of March 31, 2010.

The Company files income tax returns in the U.S. federal jurisdiction and in various state and foreign jurisdictions. In the normal course of business, the Company is subject to examination by relevant tax authorities. The Company is currently open to audit under the statute of limitations by the Internal Revenue Service for the calendar years ended December 31, 2006 through December 31, 2009. The Company and its subsidiaries' state and foreign tax returns are open to audit under simi