FRESH BRANDS INC
Form 10-Q
November 16, 2004

UNITED STATES
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 October 9, 2004

Commission File Number 000-32825

FRESH BRANDS, INC.

(Exact name of registrant as specified in its charter)

WISCONSIN	39-2019963
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2215 Union Avenue Sheboygan, Wisconsin	53081
(Address of principal executive offices)	(Zip Code)

Telephone number, including area code: (920) 457-4433

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 filing requirements for the past 90 days.

Yes X No ___

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

Yes X No ___

APPLICABLE ONLY TO CORPORATE ISSUERS: Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of November 15, 2004, 4,927,414 shares of Common Stock, $0.05 par value, were issued and outstanding.

FRESH BRANDS, INC.

FORM 10-Q INDEX

PART I FINANCIAL INFORMATION

Item 1. Financial Statements

FRESH BRANDS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(unaudited)

(In thousands, except share and per share data)

Assets	October 9, 2004	January 3, 2004
Current assets:		
Cash and equivalents	$ 11,107	$ 6,260
Receivables, net	9,310	12,520
Inventories	36,785	33,675

Land and building under development		90		4,926
Other current assets		11,206		10,781
Total current assets		68,498		68,162
Noncurrent receivable under capital subleases		22,926		33,296
Property and equipment, net		35,270		31,233
Property under capital leases, net		39,903		22,453
Goodwill		21,455		20,280
Other noncurrent assets, net		6,207		6,264
Total assets	$	194,259	$	181,688
Liabilities and Shareholders' Investment				
Current liabilities:				
Accounts payable	$	31,444	$	36,251
Accrued liabilities		16,577		12,785
Current obligations under capital leases		2,736		2,367
Current maturities of consolidated franchise debt		2,023		--
Current maturities of long-term debt		251		316
Total current liabilities		53,031		51,719
Long-term obligations under capital leases		66,536		58,857
Long-term debt under revolving line of credit		19,100		17,150
Long-term debt of consolidated franchises		7,110		--
Other long-term debt		492		677
Other noncurrent liabilities		351		2,777
Minority interests		524		--
Shareholders' investment:				
Common stock, $0.05 par value, authorized 20,000,000 shares, issued 8,750,342 shares		438		438
Additional paid-in capital		15,575		15,575
Retained earnings		76,211		79,750
Treasury stock at cost, 3,822,928 shares as of October 9, 2004 and 3,841,191 shares as of January 3, 2004		(45,109)		(45,255)
Total shareholders' investment		47,115		50,508
Total liabilities and shareholders' investment	$	194,259	$	181,688

See notes to condensed consolidated financial statements.

FRESH BRANDS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(unaudited)

(In thousands, except per share data)

	For the 12-weeks ended		For the 40-weeks ended	
	October 9, 2004	October 4, 2003	October 9, 2004	October 4, 2003

Net sales	$ 154,263	$ 139,582	$ 513,806	$ 450,482
Cost of products sold	121,087	113,340	404,928	363,088
Gross profit	33,176	26,242	108,878	87,394
Selling and administrative expenses	28,471	21,702	96,739	70,161
Depreciation and amortization	2,858	2,234	9,252	6,420
Operating income	1,847	2,306	2,887	10,813
Interest expense	(764)	(704)	(2,357)	(1,738)
Interest expense of consolidated franchises	(254)	--	(886)	--
Minority interest in earnings of consolidated franchises	(135)	--	(199)	--
Income (loss) from continuing operations before income tax	694	1,602	(555)	9,075
Income tax provision (benefit)	95	626	(356)	3,530
Income (loss) from continuing operations	599	976	(199)	5,545
Loss from discontinued operations, net of tax	(276)	(292)	(3,204)	(1,286)
Cumulative effect of change in accounting principle	--	--	(136)	--
Net income (loss)	$ 323	$ 684	$ (3,539)	$ 4,259
Earnings (loss) per basic share:				
Income (loss) from continuing operations	$ 0.12	$ 0.19	$ (0.04)	$ 1.10
Loss from discontinued operations	(0.05)	(0.05)	(0.65)	(0.26)
Cumulative effect of change in accounting principle	--	--	(0.03)	--
Earnings (loss) per basic share	$ 0.07	$ 0.14	$ (0.72)	$ 0.84
Earnings (loss) per diluted share:				
Income (loss) from continuing operations	$ 0.12	$ 0.19	$ (0.04)	$ 1.09
Loss from discontinued operations	(0.05)	(0.05)	(0.65)	(0.25)
Cumulative effect of change in accounting principle	--	--	(0.03)	--
Earnings (loss) per diluted share	$ 0.07	$ 0.14	$ (0.72)	$ 0.84
Weighted average shares and equivalents outstanding:				
Basic	4,927	5,026	4,917	5,041
Diluted	4,927	5,058	4,917	5,074
Cash dividends paid per share of common stock	$ --	$ 0.09	$ --	$ 0.27

See notes to condensed consolidated financial statements.

FRESH BRANDS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)

(In thousands)

	For the 40-weeks ended October 9, 2004	For the 40-weeks ended October 4, 2003
Cash flows from operating activities:		
Net income (loss)	$ (3,539)	$ 4,259
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	9,376	6,884
Provisions for store closures	4,359	--
Property and equipment impairment charges	1,511	--
Deferred income taxes	(12)	--
Minority interest	199	--
Cumulative effect of change in accounting principles	136	--
Changes in assets and liabilities:		
Receivables, net	1,380	(3,487)
Inventories	3,297	(1,496)
Other current assets	(2,031)	2,943
Accounts payable	(7,407)	3,218
Accrued liabilities	(2,469)	68
Net cash flows provided by operating activities	4,800	12,389
Cash flows from investing activities:		
Capital expenditures	(4,150)	(10,544)
Proceeds from sale of store	1,111	--
Expenditures for land and buildings under development	(1,941)	(8,305)
Proceeds from sale of land and buildings under development	6,776	6,612
Receipt of principal amounts under capital subleases	915	887
Net cash flows provided by (used in) investing activities	2,711	(11,350)
Cash flows from financing activities:		
Net change in revolver activity	1,950	1,250
Principal payments on capital lease obligations	(1,956)	(1,657)
Principal payments of consolidated franchise debt	(1,926)	--
Principal payments on long-term debt	(250)	(250)
Deferred financing costs	(512)	--
Distributions to minority interests	(186)	--
Payment of cash dividends	--	(1,361)
Payment for acquisition of treasury stock	--	(2,375)
Exercise of stock options	--	644
Other financing activities	101	30
Net cash flows used in financing activities	(2,779)	(3,719)
Cash and equivalents:		
Net change	4,732	(2,680)
Cash of consolidated franchises at beginning of period	115	--

Balance, beginning of period		6,260		14,250
Balance, end of period	$	11,107	$	11,570
Supplemental cash flow disclosures:				
Interest paid	$	3,219	$	1,835
Income taxes (refunded) paid		(1,500)		2,059

See notes to condensed consolidated financial statements.

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FRESH BRANDS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(1) Basis of Presentation

The condensed consolidated financial statements included herein have been prepared by us without audit. Although certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted, we believe that the disclosures are adequate to make the information presented not misleading. The interim financial statements furnished with this report reflect all adjustments (consisting of a normal recurring nature), which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. It is suggested that these financial statements be read in conjunction with the financial statements and the notes thereto included in our Form 10-K for the fiscal year ended January 3, 2004.

Annually, our fiscal year ends on the Saturday closest to December 31. As such, the current fiscal year is a 52-week period while the prior year was a 53-week period. Consistent with 2003, our first quarter of 2004 is comprised of 16-weeks and the second and third quarters consisting of 12-weeks each. The fourth quarter for 2004 is made up of 12-weeks but the fourth quarter of 2003 consisted of 13-weeks.

Certain 2003 amounts have been reclassified to conform to the presentation for 2004.

(2) Consolidation of Certain Franchisees

In December 2003, the FASB issued revised Interpretation No. 46 (FIN 46R), Consolidation of Variable Interest Entities an interpretation of Accounting Research Bulletin No. 51'". FIN 46R is intended to clarify the application of the majority voting interest requirement of ARB No. 51, Consolidated Financial Statements , to certain entities in which the equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. These entities are deemed to be variable interest entities (VIEs) under FIN 46R. The controlling financial interest in a VIE may be achieved through arrangements that do not involve voting interests.

In the past, we have provided credit enhancements to certain of our franchisees in the form of lease and sublease arrangements and loan guarantees. As a result, we have completed an evaluation of the financial arrangements with our franchisees and have concluded that we are required to consolidate certain of these franchisees, primarily as a result of our loan guarantees to these entities. We have adopted the requirement to consolidate these entities as of January 4, 2004. Prior to 2004, we recorded our exposure to losses through these credit enhancement arrangements through our provisions for bad debts. The cumulative-effect adjustment of $136,000 represents the difference between consolidating these entities as January 4, 2004 and the allowance for doubtful accounts that was provided for these franchisees at that date.

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The following table reflects the impact of consolidating the accounts of the entities as of January 4, 2004:

(In thousands)

	Fresh Brands, Inc.	Consolidated Franchisees	Eliminations	Adjusted Balances
Current assets	$ 68,162	$ 8,216	$ (3,640)	$ 72,738
Noncurrent receivable under capital subleases	33,296	--	(9,349)	23,947
Property and equipment, net	31,233	8,762	--	39,995
Property under capital leases, net	22,453	9,173	--	31,626
Goodwill	20,280	1,175	--	21,455
Other noncurrent assets	6,264	321	(770)	5,815
Total assets	$ 181,688	$ 27,647	$ (13,759)	$ 195,576
Current liabilities	$ 51,719	$ 12,234	$ (5,541)	$ 58,412
Long-term capital lease obligations	58,857	9,096	(9,096)	58,857
Revolving line of credit	17,150	--	--	17,150
Other long-term debt	677	8,811	--	9,488
Other noncurrent liabilities	2,777	--	(1,991)	786
Minority interests	--	--	511	511
Shareholders' investment	50,508	(2,494)	2,358	50,372
Total liabilities and shareholders' investment	$ 181,688	$ 27,647	$ (13,759)	$ 195,576

As discussed in Note 4, we sold two of our corporate stores to a new franchisee in September 2004. We have added this new franchisee to the group of consolidated franchisees and there are currently 17 franchise entities consolidated under FIN 46R. The following table reflects the effect of consolidation of these entities on our Unaudited Condensed Consolidated Statement of Earnings for the periods ended October 9, 2004:

(In thousands)

	For the 12-weeks ended October 9, 2004	For the 40-weeks ended October 9, 2004
Franchise retail sales	$ 27,511	$ 87,842
Eliminations in consolidation	(13,248)	(43,094)
Net impact on consolidated net sales	$ 14,263	$ 44,748
Operating income of consolidated franchise entities	$ 4	$ 120
Interest expense of consolidated franchise entities	(254)	(886)
Net losses of consolidated franchise entities	(250)	(766)
Minority interest in earnings	(135)	(199)
Eliminations in consolidation	280	933
Net impact on consolidated income before income taxes	$ (105)	$ (32)

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(3) Retail Repositioning Reserve

We estimate repositioning and termination expenses associated with the closure, replacement, or disposal of stores in accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. The following table reflects the changes in the retail repositioning reserve for the 40 weeks ended October 9, 2004.

(In thousands)

	Balance January 3, 2004	Provision	Usage	Balance October 9, 2004
Lease costs	$ 636	$ 4,359	$ (1,795)	$ 3,200

The provisions were charged to our operating segments or discontinued operations as follows:

(In thousands)

	For the 12-weeks ended October 9, 2004	For the 40-weeks ended October 9, 2004
Operating segments:		
Wholesale	$ --	$ 1,315
Discontinued operations	--	3,044
Total provision	$ --	$ 4,359

(4) Discontinued Operations

During the third quarter of 2004, we sold our three remaining corporate Piggly Wiggly stores in Illinois. We will no longer supply one of the stores and, as a result, its results of operations have been reclassified as discontinued operations. We received $1.1 million in proceeds from the sale of this store which approximated the book value of the store. The other two stores were sold to a new franchisee and will continue to be supplied by our wholesale operations. In connection with the sale of these stores, we have recognized an impairment charge of $1.3 million ($0.8 million after-tax, or $0.16 per diluted share), which was charged to the corporate retail operating segment in the second quarter of 2004 and is included in selling and administrative expenses.

Discontinued operations include the operating results of stores that we have closed or sold where we no longer have continuing involvement in those specific markets. They include one store closed in December 2003, five stores closed in May 2004, and the one store that we sold in August 2004 that we no longer supply.

The following table reflects the components of discontinued operations:

(In thousands)

	For the 12-weeks ended		For the 40-weeks ended	
	October 9, 2004	October 4, 2003	October 9, 2004	October 4, 2003
Sales	$ 1,115	$ 13,032	$ 17,524	$ 41,974

Loss from operations	$	(195)	$	(481)	$	(2,243)	$	(2,094)
Loss on disposal		--		--		(3,044)		--
Operating loss		(195)		(481)		(5,287)		(2,094)
Income tax provision (benefit)		81		(189)		(2,083)		(808)
Loss from discontinued operations	$	(276)	$	(292)	$	(3,204)	$	(1,286)

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(5) Stock-Based Compensation

We account for stock-based employee compensation plans under the guidance of APB Opinion No. 25, Accounting for Stock Issued to Employees. No compensation expense is reflected in net income for the third quarter or year-to-date periods of 2004 or 2003. The following pro-forma amounts illustrate the effect on net earnings and earnings per share for the third quarter or year-to-date periods of 2004 and 2003 if we had determined compensation cost based on the fair value at the grant date for stock options using the fair value recognition provisions of Statement of Financial Accounting Standards SFAS No. 123, Accounting for Stock-Based Compensation, to stock based employee compensation:

(In thousands, except per share data)

	For the 12-weeks ended				For the 40-weeks ended			
	October 9, 2004		October 4, 2003		October 9, 2004		October 4, 2003	
Net income (loss)								
As reported	$	323	$	684	$	(3,539)	$	4,259
Pro forma		258		582		(3,757)		3,928
Earnings (loss) per share-basic								
As reported	$	0.07	$	0.14	$	(0.72)	$	0.84
Pro forma	$	0.05	$	0.12	$	(0.76)	$	0.78
Earnings (loss) per share-diluted								
As reported	$	0.07	$	0.14	$	(0.72)	$	0.84
Pro forma	$	0.05	$	0.12	$	(0.76)	$	0.77

(6) Commitments and Contingent Liabilities

In addition to the debt of the consolidated franchisees pursuant to FIN 46R, we have guaranteed bank loans of 15 franchisees and certain of their affiliates as of October 9, 2004. These guarantees were made to support the business growth of our franchisees and our wholesale operations. The guarantees are for the terms of the loan agreements. Under these guarantees, we generally would be required to make the loan payments if the franchisee defaults on a payment. Generally, the guarantees are secured by corporate indemnification agreements and personal guarantees of the franchisee owner and are substantially collateralized with equipment and inventory, and in certain cases, with buildings. At October 9, 2004 our loss exposure under these guarantees totaled $6,243,000, and we have accrued $210,000 recorded in other long-term liabilities, for our obligations under these guarantees which represents an estimate of the fair value of these guarantees.

(7) Segment Reporting

Our operations are classified into three segments, wholesale, corporate retail and franchise retail. Our wholesale business derives its revenues primarily from the sale of groceries, produce, dairy, meat and other products to our corporate and franchised supermarkets and independent supermarket customers. We supply grocery, frozen food, produce and general merchandise and health and beauty care to our supermarkets through two distribution centers in Sheboygan, Wisconsin. We also provide our supermarkets with fresh, frozen and processed meats, eggs, dairy and deli items through a third-party distribution facility in Milwaukee, Wisconsin. Additionally, we distribute bakery and deli items made in our Platteville, Wisconsin centralized production facility. For consolidated accounting purposes, we eliminate the wholesale revenues to our corporate and consolidated franchise supermarkets. As of October 9, 2004 our corporate retail business consists of our 21 owned supermarkets and 2 convenience stores. Our retail revenue is generated by our corporate supermarkets selling products, including products purchased from our wholesale segment, to retail consumers. The 17 consolidated franchise entities comprise the franchise retail segment.

Summarized financial information for the third quarter and year-to-date periods of 2004 and 2003 concerning our reportable segments is shown in the following tables:

(In thousands)

	For the 12-weeks ended		For the 40-weeks ended	
	October 9, 2004	October 4, 2003	October 9, 2004	October 4, 2003
Net sales				
Wholesale	$ 107,370	$ 116,193	$ 367,241	$ 377,135
Corporate Retail	64,692	64,005	220,847	202,142
Franchise Retail	27,511	--	87,842	--
Intersegment eliminations:				
Sales to corporate retail	(32,062)	(40,616)	(119,030)	(128,795)
Sales to franchise retail	(13,248)	--	(43,094)	--
Total net sales	$ 154,263	$ 139,582	$ 513,806	$ 450,482

	For the 12-weeks ended		For the 40-weeks ended	
	October 9, 2004	October 4, 2003	October 9, 2004	October 4, 2003
Income (loss) from continuing operations before income tax				
Wholesale	$ 2,658	$ 3,270	$ 5,689	$ 13,061
Corporate Retail	(1,127)	(964)	(3,999)	(2,248)
Franchise Retail	4	--	120	--
Intersegment eliminations	312	--	1,077	--
Total operating income	1,847	2,306	2,887	10,813
Interest expense	(764)	(704)	(2,357)	(1,738)
Interest expense of consolidated franchises	(254)	--	(886)	--
Minority interest in earnings of consolidated franchises	(135)	--	(199)	--
Income (loss) from continuing operations before income tax	$ 694	$ 1,602	$ (555)	$ 9,075

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

General

As of October 9, 2004, we owned 21 supermarkets and 2 convenience stores and franchised an additional 79 supermarkets. This compares to 29 owned supermarkets and 74 franchised supermarkets as of October 4, 2003. Twelve of our corporate supermarkets operate under the Piggly Wiggly® banner, 9 of them operate under the Dick s® Supermarkets banner and all of our franchised supermarkets operated under the Piggly Wiggly banner. We are the primary supplier to all of these supermarkets and also serve as a wholesaler to a number of smaller, independently operated supermarkets and convenience stores. All of our supermarkets and other wholesale customers are located in Wisconsin, northern Illinois and Iowa.

Our operations are classified into three segments, wholesale, corporate retail and franchise retail. Our wholesale business derives its revenues primarily from the sale of groceries, produce, dairy, meat and other products to our corporate and franchised supermarkets and independent retail customers. We supply grocery, frozen food, produce, general merchandise and health and beauty care to our supermarkets through two distribution centers in Sheboygan, Wisconsin. We also provide our supermarkets with dairy, fresh, frozen and processed meats, eggs and deli items through a third-party distribution facility in Milwaukee, Wisconsin. Additionally, we distribute items made in our Platteville, Wisconsin centralized bakery/deli production facility. For consolidation accounting purposes, we eliminate the wholesale revenues to our corporate and consolidated franchise supermarkets.

Our corporate retail business consists of the 21 corporate-owned supermarkets and 2 convenience stores which operate under the Piggly Wiggly and Dick s Supermarkets banners. We earn our retail revenue by selling products purchased from our wholesale segment and other merchandise to retail consumers. Compared to our wholesale segment, our corporate retail segment generates higher gross profit margins, but has higher operating expenses.

As discussed in the notes to the condensed consolidated financial statements, we were required to consolidate the financial statements of certain of our franchise entities in our consolidated financial statements as of January 4, 2004 even though we have no equity interests in these franchises. There are currently 17 franchise entities that comprise our franchise retail segment. Similar to our corporate retail segment, our franchise retail segment generates higher gross profit margins, but has higher operating expenses compared to our wholesale segment.

An important part of our objective to improve operating results has been to reestablish our in-store value proposition. We believe this is a key component to reinvigorate our program and enable us to prosper against other conventional operators and compete with those whose primary focus is price. We have devoted significant effort this year to refine our program to both better appeal to the budget-minded consumer and maintain the high quality of our perishables and service. During the third quarter of 2004, we refined our competitive pricing and marketing strategy and have rolled out our new in-store value proposition to all of our corporate and franchised Piggly Wiggly stores, with the formal launch of this program occurring in early November 2004. We believe that our new pricing and marketing strategy will significantly increase the sales volumes of both our corporate and franchise stores during 2005. Initially, the impact of the new competitive prices will likely result in lower retail gross margins. However, we believe we will recover this investment in gross margins, through increased sales, an improved retail sales mix, increased leveraging of fixed store expenses, and continued controls over other store operating expenses. We do not expect to realize the full benefits of our new pricing and marketing strategy until the second half of 2005.

Results of Operations

The following tables set forth certain items from our results of operations for the third quarter and year-to-date of 2004 compared to the third quarter and year-to-date of 2003:

(In thousands)

	For the 12-weeks ended	For the 40-weeks ended

		October 9, 2004		October 4, 2003		October 9, 2004		October 4, 2003
Net sales	$	154,263	$	139,582	$	513,806	$	450,482
Gross profit		33,176		26,242		108,878		87,394
Gross margin rate (1)		21.51%		18.80%		21.19%		19.40%
Selling and administrative expenses		28,471		21,702		96,739		70,161
Selling and administrative expense rate (1)		18.46%		15.55%		18.83%		15.57%
Depreciation and amortization		2,858		2,234		9,252		6,420
Depreciation and amortization expense rate (1)		1.85%		1.60%		1.80%		1.43%
Operating income		1,847		2,306		2,887		10,813
Operating margin rate (1)		1.20%		1.65%		0.56%		2.40%
Interest expense		(764)		(704)		(2,357)		(1,738)
Interest expense of consolidated franchises		(254)		--		(886)		--
Minority interest in earnings of consolidated franchises		(135)		--		(199)		--
Income (loss) from continuing operations before income taxes		694		1,602		(555)		9,075
Income tax provision (benefit)		95		626		(356)		3,530
Effective tax rate		13.7%		39.1%		(64.1)%		38.9%
Income (loss) from continuing operations		599		976		(199)		5,545
Loss from discontinued operations, net of tax		(276)		(292)		(3,204)		(1,286)
Cumulative effect of change in accounting principle		--		--		(136)		--
Net income (loss)	$	323	$	684	$	(3,539)	$	4,259

(1) These amounts are expressed as a percent of net sales.

As indicated above, we were required to consolidate the financial statements of certain of our franchise entities in our consolidated financial statements as of January 4, 2004. The inclusion of the 17 entities currently being consolidated is the primary cause of the significant fluctuations in net sales, gross profit, selling and administrative expenses, and depreciation and amortization in the third quarter and year-to-date of 2004, compared to the third quarter and year-to-date of 2003. A discussion of our operating results by segment follows.

	For the 12-weeks ended		For the 40-weeks ended	
(In thousands)	October 9, 2004	October 4, 2003	October 9, 2004	October 4, 2003

Segment information