

STARTEK INC
Form 10-Q
November 09, 2006

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

Form 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

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 1-12793

StarTek, Inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

84-1370538

*(I.R.S. employer
Identification No.)*

**44 Cook Street, 4th Floor
Denver, Colorado**

(Address of principal executive offices)

80206

(Zip code)

(303) 399-2400

(Registrant's telephone number, including area code)

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

| Title of Each Class | Name of Each Exchange on Which Registered |
|-------------------------------|--|
| Common Stock, \$.01 par value | New York Stock Exchange, Inc. |

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

None

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). 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, \$0.01 Par Value 14,695,791 shares as of November 1, 2006.

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Condensed Consolidated Statements of Operations

(Dollars in thousands, except per share data)

(Unaudited)

| | Three Months Ended | | Nine Months Ended | |
|---|--------------------|-----------|-------------------|------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Revenue | \$ 61,865 | \$ 53,877 | \$ 178,495 | \$ 158,206 |
| Cost of services | 52,104 | 41,353 | 150,758 | 121,645 |
| Gross profit | 9,761 | 12,524 | 27,737 | 36,561 |
| Selling, general and administrative expenses | 7,533 | 7,190 | 22,495 | 21,402 |
| Operating profit | 2,228 | 5,334 | 5,242 | 15,159 |
| Net interest and other income | 337 | 1,060 | 1,403 | 1,098 |
| Income from continuing operations before income taxes | 2,565 | 6,394 | 6,645 | 16,257 |
| Income tax expense | 995 | 2,743 | 2,114 | 6,584 |
| Income from continuing operations | 1,570 | 3,651 | 4,531 | 9,673 |
| Discontinued operations: | | | | |
| Loss from operations of discontinued operations | | (820) | | (1,942) |
| Income tax benefit | | 343 | | 732 |
| Loss from discontinued operations, net of tax | | (477) | | (1,210) |
| Net income | \$ 1,570 | \$ 3,174 | \$ 4,531 | \$ 8,463 |
| Net income per share from continuing operations: | | | | |
| Basic | \$ 0.11 | \$ 0.25 | \$ 0.31 | \$ 0.66 |
| Diluted | \$ 0.11 | \$ 0.25 | \$ 0.31 | \$ 0.66 |
| Net income per share including discontinued operations: | | | | |
| Basic | \$ 0.11 | \$ 0.22 | \$ 0.31 | \$ 0.58 |
| Diluted | \$ 0.11 | \$ 0.22 | \$ 0.31 | \$ 0.58 |
| Dividends declared per common share | \$ 0.25 | \$ 0.36 | \$ 0.75 | \$ 1.08 |

See notes to condensed consolidated financial statements.

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STARTEK, INC. AND SUBSIDIARIES
Condensed Consolidated Balance Sheets
(Dollars in thousands)

| | September 30, 2006 | December 31, 2005 |
|--|-------------------------------|------------------------------|
| | (Unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 9,270 | \$ 17,425 |
| Investments | 17,995 | 28,168 |
| Trade accounts receivable, less allowance for doubtful accounts of \$4 and \$250, respectively | 47,870 | 40,612 |
| Income tax receivable | 1,235 | 4,227 |
| Prepaid expenses | 2,054 | 2,958 |
| Other current assets | 76 | 203 |
| Total current assets | 78,500 | 93,593 |
| Property, plant and equipment, net | 61,281 | 57,066 |
| Long-term deferred tax assets | 3,931 | 2,402 |
| Note receivable | 740 | 740 |
| Deposits | 232 | 113 |
| Other assets | 438 | |
| Total assets | \$ 145,122 | \$ 153,914 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 4,886 | \$ 4,744 |
| Accrued liabilities: | | |
| Accrued payroll | 5,257 | 7,280 |
| Accrued compensated absences | 3,986 | 3,522 |
| Accrued health insurance | 112 | 462 |
| Other accrued liabilities | 300 | 806 |
| Current portion of long-term debt | 2,621 | 2,551 |
| Short-term deferred income tax liabilities | 1,092 | 1,108 |
| Grant advances | 1,184 | 1,150 |
| Other current liabilities | 297 | |
| Total current liabilities | 19,735 | 21,623 |
| Long-term debt, less current portion | 1,141 | 3,099 |
| Long-term deferred rent | 1,554 | 247 |
| Other liabilities | 955 | 781 |
| Total liabilities | 23,385 | 25,750 |
| Stockholders' equity: | | |
| Common stock | 147 | 146 |
| Additional paid-in capital | 61,627 | 60,139 |

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| | | |
|--|------------|------------|
| Accumulated other comprehensive income | 1,945 | 1,776 |
| Retained earnings | 58,018 | 66,103 |
| Total stockholders' equity | 121,737 | 128,164 |
| Total liabilities and stockholders' equity | \$ 145,122 | \$ 153,914 |

See notes to condensed consolidated financial statements.

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STARTEK, INC. AND SUBSIDIARIES
Condensed Consolidated Statements of Cash Flows
(Dollars in thousands)
(Unaudited)

| | Nine Months Ended | |
|--|--------------------------|-------------|
| | September 30, | |
| | 2006 | 2005 |
| Operating Activities | | |
| Net income | \$ 4,531 | \$ 8,463 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Depreciation | 12,468 | 9,744 |
| Non-cash compensation cost | 242 | |
| Deferred income taxes | (1,528) | (943) |
| Realized (gain) loss on investments | (36) | 711 |
| Gain on sale of assets | (98) | (857) |
| Changes in operating assets and liabilities: | | |
| Sales of trading securities, net | | 2,940 |
| Trade accounts receivable, net | (7,258) | 12,371 |
| Prepaid expenses and other assets | 348 | 416 |
| Accounts payable | 143 | (3,114) |
| Income taxes receivable, net | 2,992 | 10,794 |
| Accrued and other liabilities | (604) | (486) |
| Net cash provided by operating activities | 11,200 | 40,039 |
| Investing Activities | | |
| Purchases of investments available for sale | (200,355) | (633,045) |
| Proceeds from disposition of investments available for sale | 210,604 | 617,405 |
| Purchases of property, plant and equipment | (16,116) | (7,315) |
| Proceeds from disposition of property, plant and equipment | 343 | 1,292 |
| Net cash used in investing activities | (5,524) | (21,663) |
| Financing Activities | | |
| Proceeds from stock option exercises | 1,112 | 295 |
| Principal payments on borrowings | (1,888) | (3,950) |
| Dividend payments | (12,616) | (16,676) |
| Proceeds from borrowings | | 880 |
| Net cash used in financing activities | (13,392) | (19,451) |
| Effect of exchange rate changes on cash | (439) | 451 |
| Net decrease in cash and cash equivalents | (8,155) | (624) |
| Cash and cash equivalents at beginning of period | 17,425 | 14,609 |
| Cash and cash equivalents at end of period | \$ 9,270 | \$ 13,985 |

Supplemental Disclosure of Cash Flow Information:

| | | | | |
|---|----|-------|----|-------|
| Cash paid for interest | \$ | 130 | \$ | 198 |
| Income taxes paid | \$ | 2,389 | \$ | 3,510 |
| Change in unrealized gain on investments available for sale, net of tax | \$ | 25 | \$ | (575) |

See notes to condensed consolidated financial statements.

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STARTEK, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data, unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. These unaudited financial statements reflect all estimates and adjustments (consisting only of normal recurring entries, except as noted) which, in the opinion of management, are necessary for fair presentation of the condensed consolidated balance sheets as of September 30, 2006, and December 31, 2005, the condensed consolidated statements of operations for the three and nine months ended September 30, 2006, and 2005, and the condensed consolidated statements of cash flows for the nine months ended September 30, 2006, and 2005. Operating results during the three and nine months ended September 30, 2006, are not necessarily indicative of operating results that may be expected during any other interim period of 2006 or the year ending December 31, 2006.

The consolidated balance sheet as of December 31, 2005, was derived from audited financial statements at that date, but does not include all information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. For further information, refer to the consolidated financial statements and footnotes thereto included in the StarTek, Inc. Annual Report on Form 10-K for the year ended December 31, 2005.

Certain reclassifications have been made to 2005 information to conform to 2006 presentation.

Unless otherwise noted in this report, any description of "us" refers to StarTek, Inc. and our subsidiaries. Unless otherwise indicated, currency translations into U.S. dollars are calculated using prevailing foreign currency exchange rates as of September 30, 2006, for all assets and liabilities of our foreign operations. Revenues and expenses incurred in foreign currencies are translated at the weighted-average exchange rate during the reporting period.

New Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("FAS No. 123(R)"), which replaces SFAS No. 123, "Accounting for Stock Issued to Employees." We adopted FAS No. 123(R) on January 1, 2006. The impact of the adoption of FAS No. 123(R) is discussed in Note 9.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes," an Interpretation of FASB Statement No. 109 ("FIN 48"). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 is effective for fiscal years beginning after December 15, 2006. As such, we will be required to adopt FIN 48 in the first quarter of 2007. We are currently evaluating FIN 48 and have not yet determined the impact, if any, the adoption of FIN 48 will have on our consolidated financial position or results of operations.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, "Fair Value Measurements" ("FAS No. 157"). FAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. We are currently evaluating FAS No. 157 and have not yet determined the impact, if any, that adoption of FAS No. 157 will have on our consolidated financial position or results of operations.

In September 2006, the U.S. Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" ("SAB No. 108"). SAB No. 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for the purpose of determining if the current year financial statements are materially misstated. In the year of initial adoption, SAB No. 108 permits registrants to record the cumulative effect of initial adoption by recording the necessary correcting adjustments that are material under the dual method to the carrying values of assets or liabilities as of the beginning of that year, with

an offsetting adjustment recorded in retained earnings. SAB No. 108 is effective no later than the first fiscal year ending after November 15, 2006. We are currently evaluating SAB No. 108 and have not yet determined the impact, if any, that adoption of SAB No. 108 will have on our consolidated financial position or results of operations.

Table of Contents**2. Net Income Per Share**

Basic and diluted net income per common share is computed on the basis of our weighted average number of common shares outstanding, as determined by using the calculations outlined below:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|-------------|--|-------------|
| | 2006 | 2005 | 2006 | 2005 |
| | (in thousands, except per share amounts) | | | |
| Net income available to common shareholders from continuing operations | \$ 1,570 | \$ 3,651 | \$ 4,531 | \$ 9,673 |
| Loss from discontinued operations | | (477) | | (1,210) |
| Net income | \$ 1,570 | \$ 3,174 | \$ 4,531 | \$ 8,463 |
| Weighted average shares of common stock | 14,696 | 14,631 | 14,674 | 14,628 |
| Dilutive effect of stock options | | 42 | 41 | 48 |
| Common stock and common stock equivalents | 14,696 | 14,673 | 14,715 | 14,676 |
| Basic net income (loss) per share: | | | | |
| Continuing operations | \$ 0.11 | \$ 0.25 | \$ 0.31 | \$ 0.66 |
| Discontinued operations | | (0.03) | | (0.08) |
| Net income per basic share | \$ 0.11 | \$ 0.22 | \$ 0.31 | \$ 0.58 |
| Diluted net income (loss) per share: | | | | |
| Continuing operations | \$ 0.11 | \$ 0.25 | \$ 0.31 | \$ 0.66 |
| Discontinued operations | | (0.03) | | (0.08) |
| Net income per diluted share | \$ 0.11 | \$ 0.22 | \$ 0.31 | \$ 0.58 |

Diluted earnings per share is computed on the basis of our weighted average number of common shares outstanding plus the effect of dilutive outstanding stock options using the treasury stock method. Anti-dilutive securities totaling 760,640 and 291,635 shares in the three and nine months ended September 30, 2006, respectively, and 727,280 and 555,138 shares in the three and nine months ended September 30, 2005, respectively, were not included in our calculation because the stock options exercise prices were greater than the average market price of the common shares during the periods presented.

3. Investments

As of September 30, 2006, investments available for sale consisted of:

| | Basis | Gross Unrealized Gains | Gross Unrealized Losses | Accumulated Interest | Estimated Fair Value |
|---------------------------|--------------|---------------------------------------|--|---------------------------------|-------------------------------------|
| Commercial paper | \$ 13,980 | \$ | \$ | \$ 15 | \$ 13,995 |
| Corporate debt securities | 4,013 | | (15) | 2 | 4,000 |
| Equity securities | (71) | 97 | (26) | | |
| Total | \$ 17,922 | \$ 97 | \$ (41) | \$ 17 | \$ 17,995 |

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As of December 31, 2005, investments available for sale consisted of:

| | Basis | Gross Unrealized Gains | Gross Unrealized Losses | Accumulated Interest | Estimated Fair Value |
|---------------------------|------------------|---------------------------------------|--|---------------------------------|-------------------------------------|
| Commercial paper | \$ 18,449 | \$ | \$ | \$ 13 | \$ 18,462 |
| Corporate debt securities | 7,995 | 7 | | | 8,002 |
| Equity securities | 1,681 | 45 | (22) | | 1,704 |
| Total | \$ 28,125 | \$ 52 | \$ (22) | \$ 13 | \$ 28,168 |

As of September 30, 2006, amortized costs and estimated fair values of investments available for sale by contractual maturity were:

| | Basis | Estimated Fair Value |
|--|------------------|---------------------------------|
| Corporate debt securities maturing within: | | |
| One year or less | \$ 4,013 | \$ 4,000 |
| Two to five years | | |
| More than five years | | |
| | \$ 4,013 | \$ 4,000 |
| Commercial paper | 13,980 | 13,995 |
| Equity securities | (71) | |
| Total | \$ 17,922 | \$ 17,995 |

As of September 30, 2006, equity securities consisted of an exchange-traded fund and a position in a publicly-traded equity security, as well as short positions against both of these securities. As of December 31, 2005, equity securities consisted of exchange-traded funds, mutual funds and publicly-traded equity securities. Corporate debt securities at September 30, 2006, consisted of variable-rate preferred debt securities. Corporate debt securities at December 31, 2005, consisted of corporate bonds and variable-rate preferred debt securities. We had no investments at September 30, 2006, and December 31, 2005, that had carried unrealized losses for longer than twelve months and no securities were deemed other-than-temporarily impaired during either period. We were not invested in any trading securities as of September 30, 2006, or December 31, 2005.

From time to time, we purchase or write option contracts to partially hedge against fluctuations in the value of our investment portfolio. All such options are publicly-traded with standard market terms. These options are recorded at fair value with changes in fair value recognized in current period earnings. We do not designate these options as hedging instruments pursuant to Statement of Financial Accounting Standards No. 133, Accounting for Derivative Instruments and Hedging Activities. Options have been an immaterial part of our overall investment portfolio and we expect them to continue to be an immaterial part of our overall risk management approach in the future. We were not invested in any options as of September 30, 2006, or December 31, 2005.

4. Principal Clients

The following table represents the concentration of revenue from continuing operations for our principal clients. Please note that the results of operations of our Supply Chain Management Services platform were classified as discontinued operations throughout 2005. Consequently, total revenue used to calculate these percentages has been adjusted accordingly and may differ from amounts previously disclosed in our filings with the Securities and Exchange Commission as well as other financial disclosures. Please refer to Note 6, *Discontinued Operations*, for discussion of management's sale of the Supply Chain Management Services platform.

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Revenue concentration by principal client was as follows:

| | Three Months Ended | | Nine Months Ended | |
|--|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Cingular Wireless, LLC (formerly AT&T Wireless Services, Inc.) | 41.2% | 51.7% | 44.2% | 54.3% |
| T-Mobile, a subsidiary of Deutsche Telekom | 20.3% | 25.9% | 21.1% | 23.6% |

During the three and nine months ended September 30, 2005, revenue from AT&T Corp. accounted for 10.9% and 11.4%, respectively, of our total revenue from continuing operations. For the three and nine months ended September 30, 2006, AT&T Corp. accounted for less than 10% of our total revenue.

Our agreement with Cingular Wireless, LLC expires in December 2006. We are currently in negotiations with Cingular to extend or renew this contract, but do not have a new signed agreement as of the date of this filing. Our contract with T-Mobile automatically renewed in September 2006 and the contract will expire in August 2007. There are no volume or revenue guarantees associated with either of these contracts.

The loss of a principal client, such as Cingular, and/or changes in timing or termination of a principal client's product launch, volume delivery or service offering would have a material adverse effect on our business, revenue, operating results, and financial condition. To limit our credit risk, management from time to time will perform credit evaluations of our clients. Although we are directly impacted by the economic conditions in which our clients operate, management does not believe substantial credit risk existed as of September 30, 2006.

5. Comprehensive Income

SFAS No. 130, Reporting Comprehensive Income, establishes standards for reporting and display of comprehensive income. Comprehensive income is defined essentially as all changes in stockholders' equity, exclusive of transactions with owners. The following represents the components of other comprehensive income:

| | Three Months Ended | | Nine Months Ended | |
|---|---------------------------|-------------|--------------------------|-------------|
| | September 30, | | September 30, | |
| | 2006 | 2005 | 2006 | 2005 |
| Net income | \$ 1,570 | \$ 3,174 | \$ 4,531 | \$ 8,463 |
| Other comprehensive income (loss): | | | | |
| Foreign currency translation adjustments, net of tax | (47) | 473 | 224 | 361 |
| Change in fair value of derivative instruments, net of tax | (106) | 743 | (80) | 743 |
| Change in unrealized gain (loss) on available for sale securities, net of tax | (1) | 46 | 25 | (575) |
| Comprehensive income | \$ 1,416 | \$ 4,436 | \$ 4,700 | \$ 8,992 |

We enter into foreign exchange contracts to hedge our anticipated operating commitments that are denominated in foreign currencies. The contracts cover periods commensurate with expected exposure, generally within six months, and are unsecured foreign exchange contracts. The market risk exposure is essentially limited to risk related to currency rate movements. During the three months ended September 30, 2006, these hedging commitments generated a gross unrealized loss of \$169. During the nine months ended September 30, 2006, these hedging commitments generated a gross unrealized loss of \$127, resulting in an unrealized gain position of \$47, net of tax. During the three and nine months ended September 30, 2005, these hedging commitments resulted in a gross unrealized gain of \$1,062. These unrealized gains and losses have been recorded in other comprehensive income. These hedging commitments also resulted in \$124 and \$747 of realized gains during the three and nine months ended September 30, 2006, respectively, and \$318 of realized gains during the three and nine months ended September 30, 2005. These realized gains were recognized in our consolidated statements of income during each respective period.

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On December 16, 2005, we sold our Supply Chain Management Services platform. In connection with the transaction, we sold all of the inventory, prepaid assets, property, plant and equipment of our Supply Chain Management Services platform to a third party for \$5,750. We received approximately \$4,700 in cash after certain adjustments at closing, in addition to a 5-year, unsecured \$740 note. The terms of the note call for the buyer to make quarterly interest payments to us at a fixed rate of 7% per annum for the first two years of the note. Thereafter, the purchaser must pay us interest plus set principal amounts, per the terms of the note, with the entire balance due on or before December 16, 2010. The results of operations of our Supply Chain Management Services platform have been classified as discontinued operations for all periods prior to its sale. During the three and nine months ended September 30, 2005, the Supply Chain Management Services platform generated revenue of \$1,201 and \$4,385, respectively. This platform generated a loss, net of tax benefit of \$343, of \$477 during the three months ended September 30, 2005, and a loss, net of tax benefit of \$732, of \$1,210 during the nine months ended September 30, 2005.

7. Litigation

We and six of our present and former directors and officers have been named as defendants in *West Palm Beach Firefighters Pension Fund v. StarTek, Inc., et al.* (U.S. District Court, District of Colorado) filed on July 8, 2005, and *John Alden v. StarTek, Inc., et al.* (U.S. District Court, District of Colorado) filed on July 20, 2005. Those actions have been consolidated by the federal court. The consolidated action is a purported class action brought on behalf of all persons (except defendants) who purchased shares of our common stock in a secondary offering by certain of our stockholders in June 2004, and in the open market between February 26, 2003, and May 5, 2005 (the Class Period). The consolidated complaint alleges that the defendants made false and misleading public statements about us and our business and prospects in the prospectus for the secondary offering, as well as in filings with the Securities and Exchange Commission and in press releases issued during the Class Period, and that the market price of our common stock was artificially inflated as a result. The complaints allege claims under Sections 11 and 15 of the Securities Act of 1933, and under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The plaintiffs in both cases seek compensatory damages on behalf of the alleged class and award of attorneys' fees and costs of litigation. We believe we have valid defenses to the claims and intend to defend the litigation vigorously. On May 23, 2006, we and the individual defendants moved the court to dismiss the action in its entirety. Two stockholder derivative lawsuits related to these aforementioned claims were also filed against various of our present and former officers and directors on November 16, 2005, and December 22, 2005, alleging breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. The derivative actions, which have been consolidated, name us as a nominal defendant. On April 18, 2006, we and the individually named defendants filed a motion to dismiss the derivative actions.

It is not possible at this time to estimate the possibility of a loss or the range of potential losses arising from these claims. We may, however, incur material legal fees with respect to our defense of these claims. The claims have been submitted to the carriers of our executive and organization liability insurance policies. The policies have primary and excess coverage that we believe will be adequate to defend this case and are subject to a retention for securities claims. These policies provide that we are responsible for the first \$1,025 in legal fees. As of November 1, 2006, we had incurred legal fees related to these suits of approximately 80% of our \$1,025 deductible.

We have been involved from time to time in other litigation arising in the normal course of business, none of which is expected by management to have a material adverse effect on our business, financial condition or results of operations.

8. Income Taxes

Our effective tax rate from continuing operations for the nine months ended September 30, 2006, was 31.8%, down from 40.5% in the same period of 2005. Primary reasons for this change were:

During the first quarter of 2006, the settlement of an outstanding tax audit allowed us to release \$410 of a reserve previously established for this audit. The release of this reserve caused basic and diluted earnings per share to be \$0.03 higher during the nine months ended September 30, 2006. The release of this reserve had no effect on the three months ended September 30, 2006.

During the quarter ended September 30, 2005, we established a \$600 tax-basis valuation allowance relating to capital loss carry-forwards that management does not believe will be offset by sufficient future capital gains before they expire. This event caused basic and diluted earnings per share to be \$0.04 lower during the third quarter and nine months ended September 30, 2005.

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We maintain two equity compensation plans, the StarTek, Inc. Stock Option Plan and the Director Option Plan (together, the Plans), for the benefit of certain of our directors, officers and employees. The compensation cost that has been charged against income for those plans during the three and nine months ended September 30, 2006, was \$89 and \$242, respectively, and is included in selling, general and administrative expense. The total income tax benefit recognized in our Condensed Consolidated Statements of Operations related to share-based compensation arrangements was \$28 and \$77, respectively, for the three and nine month periods ended September 30, 2006.

The StarTek, Inc. Stock Option Plan was formed in 1997 and is designed to provide stock options, stock appreciation rights, and incentive stock options (cumulatively referred to as options) to key employees, officers, directors (other than non-employee directors), consultants, other independent contractors and any named subsidiary designated in the plan as a participant. The option plan stipulates that up to 2,100,000 options may be granted to eligible participants and that each option is convertible to one share of StarTek, Inc. common stock. Options awards are made at the discretion of the Compensation Committee of the Board of Directors of StarTek, Inc. (the Committee), which is composed entirely of non-employee directors. Unless otherwise determined by the Committee, all options granted under the option plan vest 20% annually beginning on the first anniversary of the options grant date and expire at the earlier of: (i) ten years (or five years for participants owning greater than 10% of the voting stock) from the options grant date; (ii) three months after termination of employment for any reason other than cause or death; or (iii) six months after the participant's death; or (iv) immediately upon termination for cause. We have made exceptions to these vesting provisions for certain of our executive officers and employees, which were subject to approval by the Compensation Committee of the Board of Directors. These amended agreements have been filed with the Securities and Exchange Commission as Exhibits 10.4, 10.21 and 10.22 to our Annual Report on Form 10-K for the year ended December 31, 2005 and as Exhibit 10.26 to our Form 8-K filed on June 16, 2006. Options granted under the option plan on and after June 12, 2006, vest as to 25% of the shares on the first anniversary of the date of grant and 2.0833% of the shares each month thereafter for 36 months.

The Director Option Plan was established to provide stock options to non-employee directors who are elected to serve on the StarTek, Inc. Board of Directors (the Board) and who serve continuously from commencement of their term (the Participants). The Director Option Plan provides for stock options to be granted for a maximum of 140,000 shares of common stock. Each Participant is granted options to acquire 3,000 shares of common stock upon election to serve on the Board and is automatically granted options to acquire 3,000 shares of common stock on each date they are re-elected to the Board, typically coinciding with each annual meeting of stockholders. All options granted under the Director Option Plan fully vest upon grant and expire at the earlier of: (i) the date when the Participant's membership on the Board is terminated for cause; (ii) ten years from option grant date; or (iii) one year after the Participant's death. Prior to January 1, 2006, we accounted for stock-based awards to employees and non-employee directors under the intrinsic value recognition and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations (APB 25). Accordingly, no stock option-based employee compensation cost was recognized in the income statement prior to 2006, as all stock options granted under those plans had an exercise price that was equal to the market value of the underlying stock on the grant date. On January 1, 2006, we adopted Financial Accounting Standard No. 123(R), Share-Based Payment (FAS No. 123(R)). FAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values over the period during which the employees are required to provide services in exchange for the equity instruments. Pro forma disclosure is no longer an alternative. We adopted FAS No. 123(R) using the modified prospective method, which requires that compensation expense be recognized beginning with the effective date for all share-based payments granted after the effective date and for all awards granted to employees prior to the effective date of this statement that remain unvested on the effective date. We use the Black-Scholes method for valuing stock-based awards. The assumptions used to determine the value of our stock-based awards under the Black-Scholes method are summarized below:

| Three Months Ended September | Nine Months Ended September |
|-------------------------------------|------------------------------------|
| 30, | 30, |

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| | 2006 | 2005 | 2006 | 2005 |
|-------------------------|--------------------|--------------------|--------------------|--------------------|
| Risk-free interest rate | 4.74% - 5.05% | 3.97% - 4.18% | 4.74% - 5.11% | 3.97% - 4.18% |
| Dividend yield | 7.51% - 9.02% | 9.63% | 6.63% - 9.02% | 6.11% - 9.63% |
| Expected volatility | 42.02% - 55.00% | 46.01% - 48.69% | 42.02% - 55.00% | 29.87% - 55.00% |
| Expected life in years | 4.2 | 5 | 3.9 | 5 |

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The risk-free interest rate for periods within the contractual life of the option is based on either the four year or seven year U.S. Treasury strip yield in effect at the time of grant. Expected life and volatilities are based on historical experience, which we believe will be indicative of future experience.

The following table details the effect on net income and earnings per share had compensation expense for the share-based compensation arrangements been recorded in the three and nine month periods ended September 30, 2005 based on the Black-Scholes method:

| | Three Months Ended September 30, 2005 | Nine Months Ended September 30, 2005 |
|---|--|---|
| Net income, as reported | \$ 3,174 | \$ 8,463 |
| Share-based employee (including non-employee directors) compensation expense that would have been included in the determination of net income if the fair value method had been applied to all awards, net of tax | (828) | (1,242) |
| Pro forma net income | \$ 2,346 | \$ 7,221 |
| Basic earnings per share | | |
| As reported | \$ 0.22 | \$ 0.58 |
| Pro forma | \$ 0.16 | \$ 0.49 |
| Diluted earnings per share | | |
| As reported | \$ 0.22 | \$ 0.58 |
| Pro forma | \$ 0.16 | \$ 0.49 |

A summary of option activity under the Plans as of September 30, 2006, and changes during the nine months then ended is presented below:

| | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term | Aggregate Intrinsic Value (000s) |
|--------------------------------------|---------------|--|--|---|
| Outstanding as of January 1, 2006 | 981,490 | \$ 19.68 | | |
| Granted | 279,840 | 13.28 | | |
| Exercised | (64,700) | 17.19 | | |
| Forfeited | (175,490) | 18.06 | | |
| Outstanding as of September 30, 2006 | 1,021,140 | \$ 18.36 | 8.1 | \$ 161 |
| Exercisable as of September 30, 2006 | 429,050 | \$ 24.98 | 6.6 | \$ 21 |

The weighted-average grant-date fair value of options granted during the three and nine months ended September 30, 2006, was \$2.42 and \$2.94, respectively. The weighted-average grant-date fair value of options granted during the three and nine months ended September 30, 2005, was \$2.93, and \$2.89, respectively. The total intrinsic value of

options exercised during the nine months ended September 30, 2006, was \$353. There were no options exercised during the three months ended September 30, 2006. The total intrinsic value of options exercised during the three and nine months ended September 30, 2005, was \$1 and \$221, respectively. The fair value of nonvested shares is determined based on the closing trading price of our common shares on the grant date.

As of September 30, 2006, there was \$1,108 of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted under the Plans. That cost is expected to be recognized over a weighted-average period of 3.9 years. The total fair value of shares vested during the three and nine months ended September 30, 2006, was \$109 and \$110, respectively. The total fair value of shares vested during the three and nine months ended September 30, 2005, was \$74 and \$1,433, respectively.

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Prior to our adoption of FAS No. 123(R), we accelerated 143,860 employee stock options, all with exercise prices of \$21.80 or above, such that they immediately vested as of December 30, 2005. The purpose of this action was to eliminate future compensation expense that we would otherwise have recognized upon implementation of FAS No. 123(R). The weighted-average exercise price of the options that were accelerated was \$28.92. Because the options prior to the acceleration had intrinsic values that were more than the intrinsic value of the options after acceleration, no compensation expense related to the acceleration was recognized in our Consolidated Statements of Income for the year ended December 31, 2005. All terms of options with an exercise price of less than \$21.80 remained unchanged.

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

All statements contained in this Form 10-Q that are not statements of historical facts are forward-looking statements that involve substantial risks and uncertainties. Forward-looking statements are preceded by terms such as may, will, should, anticipates, expects, believes, plans, future, estimate, continue, intends, budgeted, projected, similar expressions. The following are important factors that could cause actual results to differ materially from those expressed or implied by such forward-looking statements. These factors include, but are not limited to, risks relating to our revenue from our principal clients, concentration of our client base in the communications industry, consolidation in the communications industry, risks relating to fluctuations in the value of our investment securities portfolio, inability to effectively manage capacity, highly competitive markets, risks related to our contracts, decreases in numbers of vendors used by clients or potential clients, lack of success of our clients' products or services, considerable pricing pressure, risks associated with advanced technologies, inability to effectively manage growth, dependence on and requirement to recruit qualified employees, including additional sales personnel, and key management personnel, potential future declines in revenue, lack of a significant international presence, and foreign exchange risks and other risks relating to conducting business in Canada. These factors include risks and uncertainties beyond our ability to control, and in many cases we cannot predict the risks and uncertainties that could cause actual results to differ materially from those indicated by use of forward-looking statements. Similarly, it is impossible for management to foresee or identify all such factors. As such, investors should not consider the foregoing list to be an exhaustive statement of all risks, uncertainties, or potentially inaccurate assumptions. All forward-looking statements herein are made as of the date hereof, and we undertake no obligation to update any such forward-looking statements. All forward-looking statements herein are qualified in their entirety by information set forth in our Annual Report on Form 10-K for the year ended December 31, 2005, entitled Management's Discussion and Analysis of Financial Condition and Results of Operations - Risk Factors.

Unless otherwise noted in this report, any description of us or we refers to StarTek, Inc. and our subsidiaries. All financial information in this report is presented in U.S. dollars.

Executive Overview

We are a leading provider of business process optimization services for outsourced customer interactions. StarTek has provided customer experience management solutions that solve strategic business challenges so that fast-moving businesses can effectively manage customer relationships across all contact points - web, voice, email, fax, and video. Headquartered in Denver, Colorado, we have 19 operational call center facilities across North America which service our business process management services platform. We also derive an immaterial amount of revenue from our Domain.com business, which manages or leases websites to third parties.

Through our business process management services platform, we provide provisioning management, complex order management, work flow management, customer care, receivables management, wireless telephone activations, high-end technical support and wireline telephone number portability services. Substantially all of our customer interactions related to business process management services are initiated by our clients' customers. We derive our revenue through contractual relationships with our clients, wherein we recognize revenue based on the billable hours or minutes of each call center agent or on a rate per transaction basis. These rates could be based on the number of paid hours the agent works, the number of minutes the agent is available to answer calls, or the number of minutes the agent is actually handling calls for the client, depending on the client contract. More than 95% of our revenue comes from clients in the communications industry.

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Our business faces considerable pressures related to pricing and diversification. It is for this reason that we seek to continuously expand our service offerings in response to the growing needs of our clients and to capitalize on market opportunities. The principal elements of our growth strategy are to:

Use our expertise in complex process management to address potential outsourcing opportunities

Strengthen strategic partnerships and long-term relationships with existing clients

Expand our client base in new and existing vertical markets

Maintain a disciplined approach to expansion and

Explore international opportunities.

We intend to capitalize on a growing trend toward outsourcing by focusing on potential clients in industries such as financial services, communications and health care, which we believe could benefit from our expertise in developing and delivering integrated, cost-effective outsourced services.

Financial results for the three and nine month periods ended September 30, 2006, were affected by the ramp of three new call centers that were placed into service during the first half of the year in response to new client business. Revenue increased 14.8% and 12.8% during the three and nine month periods ended September 30, 2006, when compared to the same periods in 2005. This revenue growth was driven by revenue from clients new to StarTek since the first half of 2005. Gross margin declined year over year for both the three and nine-month periods ended September 30, 2006, primarily as a result of costs to open and ramp the three new centers, increased attrition rates, the strengthening of the Canadian dollar versus the U.S. dollar, wage pressures and increased training costs with our largest client. Selling, general and administrative expenses as a percentage of revenue declined year over year for both the third quarter and year to date, reflecting the outcome of cost-savings initiatives implemented in 2005. Net income from continuing operations declined \$2.1 million and \$5.1 million during the three and nine months ended September 30, 2006, respectively.

Our cash and cash equivalents and investments declined \$18.3 million from December 31, 2005, to \$27.3 million as of September 30, 2006. The majority of this decrease was the result of investments in the build-out of our three new call centers. Capital expenditures during the nine months ended September 30, 2006, totaled \$16.1 million. The decline in cash and cash equivalents and investments drove a \$13.2 million decline in working capital, from \$72.0 million as of December 31, 2005, to \$58.8 million as of September 30, 2006.

Results of Operations

The following table sets forth certain unaudited condensed consolidated income statement data as a percentage of revenue from continuing operations (dollars in thousands):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|---|----------------------------------|--------|-----------|--------|---------------------------------|--------|------------|--------|
| | 2006 | | 2005 | | 2006 | | 2005 | |
| Revenue | \$ 61,865 | 100.0% | \$ 53,877 | 100.0% | \$ 178,495 | 100.0% | \$ 158,206 | 100.0% |
| Cost of services | 52,104 | 84.2% | 41,353 | 76.8% | 150,758 | 84.5% | 121,645 | 76.9% |
| Gross profit | 9,761 | 15.8% | 12,524 | 23.2% | 27,737 | 15.5% | 36,561 | 23.1% |
| Selling, general and administrative expenses | 7,533 | 12.2% | 7,190 | 13.3% | 22,495 | 12.6% | 21,402 | 13.5% |
| Operating profit | 2,228 | 3.6% | 5,334 | 9.9% | 5,242 | 2.9% | 15,159 | 9.6% |
| Net interest and other income | 337 | 0.5% | 1,060 | 2.0% | 1,403 | 0.8% | 1,098 | 0.7% |
| Income from continuing operations before income | 2,565 | 4.1% | 6,394 | 11.9% | 6,645 | 3.7% | 16,257 | 10.3% |

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| | | | | | | | | |
|-----------------------------------|----------|------|----------|------|----------|------|----------|------|
| taxes | | | | | | | | |
| Income tax expense | 995 | 1.6% | 2,743 | 5.1% | 2,114 | 1.2% | 6,584 | 4.2% |
| Income from continuing operations | 1,570 | 2.5% | 3,651 | 6.8% | 4,531 | 2.5% | 9,673 | 6.1% |
| Loss on discontinued operations | | | (477) | N/M | | | (1,210) | N/M |
| Net income | \$ 1,570 | 2.5% | \$ 3,174 | 5.9% | \$ 4,531 | 2.5% | \$ 8,463 | 5.3% |

N/M = Not meaningful.

Revenue. Third quarter 2006 revenue of \$61.9 million reflected an increase of 14.8% over the same period in the prior year. New clients launched during the previous 12 months provided us with \$12.2 million in incremental revenue during the third quarter of 2006. Total revenue from these new clients increased 39% over the previous quarter. Partially offsetting these revenue increases were declines in volume from StarTek's two largest clients, driven by fewer agents in production during the third quarter as a result of fewer operating hours, increased agents in training and attrition. Although agents generate revenue while they are in training, they do so at a lower billing rate than they would generate in production.

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Revenue for the first nine months of 2006 was \$178.5 million and reflected an increase of \$20.3 million, or 12.8%, over the same period in 2005. Clients new to StarTek since the second half of 2005 drove this increase, contributing an incremental \$28.2 million of revenue during the first nine months of 2006 compared to the same period in 2005. Partially offsetting this increase was a decline in revenue and volume from our largest client and the impact of lost revenues from a former utility client. The decline in revenue from our largest client was due to decreased production volume combined with having more agents in training in response to changes in this client's service demand.

Cost of Services and Gross Profit. Cost of services increased \$10.8 million, or 26.0%, during the third quarter of 2006 when compared to the third quarter of 2005. Gross margin during the third quarter of 2006 declined to 15.8% from 23.2% during the third quarter of 2005. The decline was primarily attributable to higher fixed carrying costs as a percentage of revenue associated with three new call centers, increased competition for labor in certain of our call center locations and some seasonality in the labor pool from which we draw. Gross margin for the quarter was also affected by a \$0.9 million foreign exchange impact of a strengthening Canadian dollar versus the U.S. dollar.

Sequentially, gross margin increased from 13.8% in the second quarter of 2006 to 15.8% in the third quarter of 2006, reflecting progress in the ramp process for our three new call centers placed into service during the first half of 2006. Year to date, cost of services increased \$29.1 million, or 23.9%, in 2006 when compared to the same period in 2005. Gross margin declined to 15.5% during the first nine months of 2006 from 23.1% during the same period in 2005. This decline was driven by costs to open three new call centers, including additional fixed costs to operate these facilities, a strengthening Canadian dollar versus the U.S. dollar, higher agent turnover and wage pressure in some markets in which we operate. Gross margin was also affected by declining margins from our largest client as this client had more agents in training as it experienced changes in its service demand.

Selling, General and Administrative Expenses. Selling, general and administrative expenses for the third quarter of 2006 increased 4.8% over the third quarter of 2005 as a result of incremental expenses needed to support three new facilities opened during 2006. However, as a percentage of revenue, selling, general and administrative expenses declined from 13.3% in the third quarter of 2005 to 12.2% during the same quarter of 2006, due in part to lower costs resulting from cost savings initiatives implemented during 2005.

For the nine months ended September 30, 2006, selling, general, and administrative expense increased \$1.1 million, or 5.1%, to \$22.5 million compared to the same period of the prior year. This change was driven by increases in costs associated with the support and opening of three new call centers, increased legal fees and FAS No. 123(R) expense. Lowered costs resulting from cost-savings initiatives implemented during 2005 partially offset this increase. As a percentage of revenue, selling, general and administrative expenses declined from 13.5% during the first nine months of 2005 to 12.6% during the same period of 2006.

Operating Profit. During the third quarter of 2006, operating profit declined \$3.1 million from the third quarter of 2005 to \$2.2 million. Operating profit declined from \$15.2 million to \$5.2 million from the first nine months of 2005 to the same period of 2006, respectively. These declines were driven by decreases in gross margin during the first half of 2006, as discussed previously.

Net Interest and Other Income. Net interest and other income during the third quarter of 2006 was \$0.3 million, representing a decline of \$0.7 million when compared to the third quarter of 2005. This decline was attributable to a \$0.8 million gain in the third quarter of 2005 resulting from the sale of a facility located in Greeley, Colorado. Our business generated \$0.3 million more net interest and other income during the nine months ended September 30, 2006, than during the same period of 2005. This increase was driven by investment losses incurred during 2005 as we repositioned our investment portfolio to conform to our current investment policy.

Income Tax Expense. Income tax expense declined \$1.7 million and \$4.5 million during the three and nine months ended September 30, 2006, respectively, compared to the same periods in the previous year. This decrease was driven by lower income before income taxes. During the nine months ended September 30, 2006, the effective tax rate was 31.8%, a decline from the same period in 2005 when the effective tax rate was 40.5%. The change in our effective tax rate year over year was partially the result of a \$0.4 million reserve reversal related to the favorable settlement of an outstanding tax audit recognized during the first quarter of 2006. The release of this reserve had the effect of decreasing our 2006 year-to-date tax rate. Additionally, in the third quarter of 2005, we created a \$0.6 million tax-basis valuation allowance related to capital loss carry-forwards that management does not believe will be offset by

sufficient future capital gains before they expire. The creation of this 2005 allowance had the effect of increasing our year-to-date 2005 effective tax rate. Please see Item 1, *Financial Information*, Note 8, *Income Taxes* for further discussion of the impact of the release of this reserve on our income tax expense during the quarter.

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Discontinued Operations. On December 16, 2005, we sold our Supply Chain Management Services platform. Consequently, the results of operations of our Supply Chain Management Services platform have been classified as discontinued operations during the three and nine months ended September 30, 2005. During the three months ended September 30, 2005, discontinued operations generated a loss of \$0.8 million, with a related income tax benefit of \$0.3 million, netting to a loss of \$0.5 million. During the nine months ended September 30, 2005, discontinued operations generated a loss of \$1.9 million and related income tax benefit of \$0.7 million, for a net impact to earnings of \$1.2 million. Please see Item 1, *Financial Information*, Note 6, *Discontinued Operations* for further discussion of the sale.

Net Income. Net income decreased \$1.6 million to \$1.6 million during the quarter ended September 30, 2006. Year to date, net income decreased from \$8.5 million in 2005 to \$4.5 million in 2006. The decrease in net income was driven by lower margins and partially offset by improvements in income tax expense and net interest and other income, as described previously in more detail.

Liquidity and Capital Resources

As of September 30, 2006, we had working capital of \$58.8 million, which represented a decline of \$13.2 million from December 31, 2005. This decline was driven by a decline of \$18.3 million in cash and cash equivalents and investments during the first nine months of 2006. This was primarily caused by capital expenditures made during the build-out of our three new call centers opened in 2006. Cash generated from operating activities was \$11.2 million during the nine months ended September 30, 2006.

We have historically financed our operations, liquidity requirements, capital expenditures, and capacity expansion primarily through cash flows from operations, and to a lesser degree through various forms of debt and leasing arrangements. In addition to funding basic operations, our primary uses of cash relate to capital expenditures to upgrade our existing information technologies, the payment of dividends, and investments in our facilities. We believe that cash flows from operations and cash provided by short-term borrowings, when necessary, will adequately meet our ongoing operating requirements and scheduled principal and interest payments on existing debt. Any significant future expansion of our business may require us to secure additional cash resources. Our liquidity could be significantly impacted by large cash requirements to expand our business or a decrease in demand for our services, particularly from any of our principal clients, which could arise from a number of factors, including, but not limited to, competitive pressures, adverse trends in the business process outsourcing market, industry consolidation, adverse circumstances with respect to the industries we service, and any of the other factors we describe more fully in the section entitled *Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2005.

Net Cash Provided by Operating Activities. Net cash provided by operating activities declined \$28.8 million during the nine months ended September 30, 2006, compared to the same period in 2005. This decline was largely attributable to a \$7.3 million increase in accounts receivable in the first nine months of 2006 compared to a \$12.4 million decrease during the first nine months of 2005. Both of these changes were largely the result of the timing of payments by a large client. In 2006, accounts receivable was also higher due to a larger revenue base in the first nine months of 2006 compared to the same period of 2005 resulting from the addition of multiple new clients since the first half of 2005. Also contributing to the decline in net cash provided by operating activities was a decline in cash provided by changes in income taxes receivable, net income and the sale of trading securities. During the nine months ended September 30, 2005, declines in income taxes receivable, net were driven by an \$8.0 million tax refund resulting from an overpayment of estimated tax liability as of December 31, 2004. Also, during the first nine months of 2005, we were in the process of repositioning our investment portfolio to conform to a new investment policy implemented in 2004. As a result, we sold \$2.9 million in trading securities in 2005, versus 2006 when we no longer hold any trading securities in our investment portfolio. A decline in net income also contributed to the decline in cash provided by operating activities. These declines were partially offset by timing of payments in our accounts payable balance year over year.

Net Cash Used in Investing Activities. Net cash used in investing activities declined \$16.1 million to \$5.5 million during the nine months ended September 30, 2006, compared to the same period in 2005. While capital expenditures increased \$8.8 million year-over-year due to the build-out of our new call center facilities in Ontario, Canada and Virginia, this was offset by changes in investment activity in 2006 versus 2005. In 2006, we sold a large portion of our

equity securities, the proceeds of which were used to help fund the build-out and subsequent ramp of three new call centers that were placed into service during the first two quarters of 2006. During the first nine months of 2005, we were in the process of implementing a more conservative investing approach and therefore were transitioning the holdings in our portfolio under the transition provisions of this new policy. This, combined with the fact that we were investing more of our cash during 2005, led to higher net investment purchases in 2005 and therefore a higher cash usage with respect to investing.

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During the first nine months of 2006, we used a significant amount of our capital expenditures for capacity expansion, and plan to use our capital expenditures for the balance of the year for continued information technology infrastructure improvements, development of new service offerings, and finishing our capacity expansion projects. We may use our capital expenditures towards further capacity expansion as it is needed. Our actual capital expenditures may vary depending on the infrastructure required in order to give quality service to our clients based on our continual assessment of capacity needs. We believe our existing facilities, including our newly re-opened facility in Laramie, Wyoming, are adequate for our current operations, but additional capacity expansion, including opening additional facilities, may be required to support our future growth. While we strive to make the best use of the operating facilities we have, management intends to maintain a certain amount of excess capacity to enable us to readily provide for the needs of new clients and the increasing needs of existing clients.

Net Cash Used in Financing Activities. Net cash used in financing activities declined \$6.1 million during the first nine months of 2006, when compared with the same period in 2005. This decline was driven by lower dividend payments and lower principal payments on borrowings. During the nine months ended September 30, 2006, we declared dividends of \$0.75 per share, a decrease of \$0.33 per share compared to the comparable dividend payments during the nine months ended September 30, 2005. In 2005, we had higher debt principal repayments due to repayments of amounts outstanding on our line of credit at the end of 2004.

Outstanding Debt. In February 2004, we entered into a secured equipment loan with Wells Fargo Equipment Finance, Inc. in the amount of \$10.0 million. The loan bears interest at a rate of 3.65% per annum. Principal and interest are payable in 48 monthly installments of \$224 thousand. The loan is secured by certain furniture, telephone and computer equipment. As of September 30, 2006, we had \$3.7 million outstanding under this loan.

We also maintain a \$10.0 million unsecured line of credit with Wells Fargo Bank, N.A. (the Bank) which we use to finance regular, short-term operating expenses. Under our current agreement, the last day under which the Bank will make advances under the line of credit will be June 30, 2007. Borrowings under this line of credit bear interest at either a fluctuating rate per annum that is 1% below the Prime Rate or at a fixed rate per annum determined by the Bank to be 1.5% above LIBOR. The interest rate on this facility was 7.25% as of September 30, 2006. Under this line of credit, we must generate net profit after tax of at least \$1 on a rolling four-quarter basis, measured quarterly, and are not permitted to incur net losses in any two consecutive quarterly periods. We were required to hold a tangible net worth of \$94.3 million at September 30, 2006, and at the close of each subsequent quarter, we are required to have a minimum tangible net worth equal to the minimum tangible net worth we were required to have at the end of the prior fiscal period plus 25% of net income (if positive). No amounts were outstanding under this line of credit as of September 30, 2006, and we were in compliance with all of our debt covenants related to this facility.

Dividend Information. We paid a cash dividend of \$0.25 per share, aggregating approximately \$3.7 million, on August 24, 2006. We also declared a dividend of \$0.25 per share, aggregating to approximately \$3.7 million, on November 1, 2006, payable on November 27, 2006, to our stockholders of record as of November 15, 2006. The payment of any future dividends will be at the discretion of our board of directors and will depend on, among other things, availability of funds, future earnings, cash flow, capital requirements, contractual restrictions, our general financial condition and business conditions.

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Contractual Obligations. Other than operating leases for certain equipment and real estate and commitments to purchase goods and services in the future, in each case as reflected in the table below, we have no significant off-balance sheet transactions, unconditional purchase obligations or similar instruments, and we are not a guarantor of any other entities' debts or other financial obligations. The following table presents a summary of our contractual obligations and payments, by period, as of September 30, 2006 (in thousands):

| | Less Than One Year | One to Three Years | Four to Five Years | More than Five Years | Total |
|-------------------------------------|-------------------------------|-------------------------------|-------------------------------|---------------------------------|--------------|
| Long-term debt ⁽¹⁾ | \$ 2,621 | \$ 1,141 | \$ | \$ | \$ 3,762 |
| Operating leases ⁽²⁾ | 4,102 | 6,929 | 4,972 | 2,319 | 18,322 |
| Purchase obligations ⁽³⁾ | 6,333 | 3,525 | | | 9,858 |
| Total contractual obligations | \$ 13,056 | \$ 11,595 | \$ 4,972 | \$ 2,319 | \$ 31,942 |

(1) Long-term debt consists of our \$10.0 million, 3.65% fixed rate equipment loan, as discussed previously, and debt associated with our Greeley North facility, which is forgiven at a rate of \$26 thousand per year as long as we remain in the facility.

(2) We lease facilities and equipment under various non-cancelable operating leases.

(3) Purchase obligations include commitments to purchase goods and services that in some cases may include provisions for cancellation.

Other Factors Impacting Liquidity. Our business currently has a high concentration on a few principal clients. The loss of a principal client and/or changes in timing or termination of a principal client's product launch or service offering would have a material adverse effect on our business, liquidity, operating results, and financial condition. These client relationships are further discussed at Item 1, *Financial Information*, Note 4, *Principal Clients*. To limit our credit risk, management from time to time will perform credit evaluations of our clients. Although we are directly impacted by the economic conditions in which our clients operate, management does not believe substantial credit risk existed as of September 30, 2006.

Effective November 4, 2004, our Board of Directors authorized purchases of up to \$25 million of our common stock. The repurchase program will remain in effect until terminated by the Board of Directors and will allow us to repurchase shares of our common stock from time to time on the open market, in block trades and in privately-negotiated transactions. Repurchases will be implemented by the Chief Financial Officer consistent with the guidelines adopted by the Board of Directors from time to time and will depend on market conditions and other factors. Any repurchased shares will be made in accordance with Securities and Exchange Commission rules. We have not yet repurchased any shares pursuant to this Board authorization.

Although management cannot accurately anticipate effects of domestic and foreign inflation on our operations, management does not believe inflation has had, or is likely in the foreseeable future to have, a material adverse effect on our results of operations or financial condition, with the exception of wage pressure. We currently face wage pressures in some of the communities in which we operate due to factors including, but not limited to, growth and low unemployment in these communities. These pressures have contributed to our current higher employee turnover rates and blanket wage increases at some of our sites, which contributes to a declination of our gross margins. While we consider these wage pressures to be present only in certain communities in which we operate, these pressures could become more widespread and could indirectly have a material adverse effect on our results of operations. Please also see Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations - Risk Factors* in our Annual Report on Form 10-K for the year ended December 31, 2005.

Variability of Operating Results

Our business has historically been seasonal only to the extent that our clients' marketing programs and product launches are geared toward the holiday buying season. For 2006, we anticipate similar variations in quarterly revenue

as has historically been the case for our business process management services, excluding the effects of our supply chain management services, which were classified as discontinued operations beginning in the fourth quarter of 2005. We have experienced and expect to continue to experience some quarterly variations in revenue and operating results due to a variety of factors, many of which are outside our control, including: (i) timing and amount of costs incurred to expand capacity in order to provide for volume growth from existing and future clients, (ii) changes in the volume of services provided to principal clients, (iii) timing of existing and future client product launches or service offerings; (iv) expiration or termination of client projects or contracts; (v) seasonal nature of certain clients' businesses; and (vi) cyclical nature of certain high technology clients' businesses.

Table of Contents**Critical Accounting Estimates**

In preparing our condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management must undertake decisions that impact the reported amounts and related disclosures. Such decisions include the selection of the appropriate accounting principles to be applied and assumptions upon which accounting estimates are based. Management applies its best judgment based on its understanding and analysis of the relevant circumstances to reach these decisions. By their nature, these judgments are subject to an inherent degree of uncertainty. Accordingly, actual results may vary significantly from the estimates we have applied.

Our critical accounting estimates are consistent with those disclosed in our Annual Report on Form 10-K for the year ended December 31, 2005, with the exception of our estimates surrounding our stock-based compensation cost, as discussed below. Please refer to Item 7, *Management's Discussion and Analysis of Financial Condition and Results of Operations*, in our Annual Report on Form 10-K for the year ended December 31, 2005, for a complete description of our Critical Accounting Estimates.

Adoption of FAS No. 123(R)

In January 2006, we adopted Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (FAS No. 123(R)), applying the modified prospective method. FAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values over the period during which the employees are required to provide services in exchange for the equity instruments. Pro forma disclosure is no longer an alternative. Prior to January 1, 2006, we accounted for share-based awards to employees and non-employee directors under the intrinsic value recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations (APB 25). Accordingly, no stock option-based employee compensation cost was recognized in the income statement prior to 2006, as all stock options granted under those plans had an exercise price that was equal to the market value of the underlying stock on the grant date. We recorded \$89 thousand and \$242 thousand in share-based compensation during the three and nine months ended September 30, 2006. We expect that share-based compensation expense for 2006 will be approximately \$320 thousand based on current outstanding awards and assumptions applied. However any significant awards granted during the remainder of 2006, required changes in estimated forfeiture rates, significant changes in the market price of our common stock, or any other change in the assumptions used to value these options may impact this estimate. See Item 1, *Financial Statements*, Note 9, *Share-Based Compensation* for further information.

Item 3: Quantitative and Qualitative Disclosure About Market Risk

In the normal course of business, we are exposed to certain market risks related to changes in interest rates and other general market risks, equity market prices, and foreign currency exchange rates. We have established an investment portfolio policy which provides for, among other things, investment objectives and portfolio allocation guidelines. This discussion contains forward-looking statements subject to risks and uncertainties. Actual results could vary materially as a result of a number of factors, including but not limited to, changes in interest and inflation rates or market expectations thereon, equity market prices, foreign currency exchange rates, and those factors set forth in our Annual Report on Form 10-K for the year ended December 31, 2005, under the heading *Management's Discussion and Analysis of Financial Condition and Results of Operations Risk Factors*.

Interest Rate Sensitivity and Other General Market Risks

Cash and Cash Equivalents. At September 30, 2006, we had \$9.3 million in cash and cash equivalents. Approximately \$2.9 million of this cash was invested in various money market funds and overnight investments at a combined weighted average interest rate of approximately 3.9%. Cash and cash equivalents are not restricted. We consider cash equivalents to be short-term, highly liquid investments readily convertible to known amounts of cash, and so near their maturity they present insignificant risk of changes in value because of changes in interest rates. We do not expect any substantial loss with respect to our cash and cash equivalents as a result of interest rate changes, and the estimated fair value of our cash and cash equivalents approximates original cost. We paid a cash dividend to stockholders of \$0.25 per share, aggregating \$3.7 million, in August 2006. We also declared a dividend of \$0.25 per share, aggregating to approximately \$3.7 million, on November 1, 2006, payable on November 27, 2006, to our

stockholders of record as of November 15, 2006.

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Outstanding Debt. We currently have two debt facilities available for use: a \$10.0 million secured equipment loan and a \$10.0 million unsecured revolving line of credit. Borrowings under the \$10.0 million secured equipment loan bear interest at a fixed rate of 3.65% per annum. As of September 30, 2006, we had \$3.7 million outstanding under this loan.

From time to time, we may borrow under our \$10.0 million line of credit for general corporate purposes, including working capital requirements, capital expenditures, and other purposes related to expansion of our capacity. As of September 30, 2006, we had no amounts outstanding on this line of credit. Borrowings under this line of credit bear interest at the lender's prime rate less 1%, which was 7.25% as of September 30, 2006, although for certain borrowings, we may elect to pay a fixed rate equal to LIBOR plus 1.5%. We believe a hypothetical 10.0% increase in interest rates would not have a material adverse effect on our financial position. Increases in interest rates would, however, increase interest expense associated with future variable-rate borrowings by us, if any. We have not historically hedged our interest rates with respect to this or any of our other loans and we do not expect to hedge these rates in the future.

As of September 30, 2006, we were in compliance with the all financial covenants pertaining to our line of credit. This line of credit is renewed every two years at the option of Wells Fargo and was last renewed in June of 2005.

Investments Available for Sale. At September 30, 2006, we had investments available for sale which, in the aggregate, had a cost basis of \$17.9 million and a fair market value of \$18.0 million. At September 30, 2006, investments available for sale generally consisted of commercial paper, exchange-traded funds, publicly-traded equity securities, and short positions on an exchange-traded fund and a publicly-traded equity security. Our investment portfolio is subject to interest and inflation rate risks and will fall in value if market interest and/or inflation rates or market expectations relating to these rates increase.

Late in 2004, we instituted a more conservative investment approach, which required us to make changes to our investment portfolio throughout the early months of 2005. We amended our investment policy in October of 2006 to further clarify our investment approach as well as the specific duties of those managing our cash and investments. Our investments typically consist of shorter-term available for sale investments and as a result, we purchase and sell investments held in our portfolio with substantially higher frequency than we have in the years prior to 2005.

Prices of publicly-traded equity securities we hold could generally be expected to be adversely affected by increasing inflation or interest rates or market expectations thereon, poor management, shrinking product demand, and other risks that may affect single companies or groups of companies, as well as adverse general economic conditions. At times we have partially hedged against some equity price changes; however, our hedging activities do not provide material protection against price fluctuations in securities we hold in our investment portfolio.

Historically, options have been an immaterial part of our overall investment portfolio, and we expect options will remain an immaterial part of our overall risk management approach in the future.

The fair market value of and estimated cash flows from our investments in corporate bonds are substantially dependent upon the credit worthiness of certain corporations expected to repay their debts to us. If such corporations financial condition and liquidity adversely changes, our investments in these bonds would be materially and adversely affected.

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The table below provides information as of September 30, 2006, about maturity dates and corresponding weighted average interest rates related to certain of our investments available for sale:

| | Weighted Average Interest Rates | | | | | | Total | Fair Value |
|---------------------------|--|-----------|------------|------------|------------|--------------------------|-----------|---------------|
| | | 1 Year | 2 Years | 3 Years | 4 Years | 5 Years Thereafter | | |
| Commercial Paper | 5.32% | \$ 13,980 | | | | | \$ 13,980 | \$ 13,995 |
| Corporate debt securities | 4.95% | 4,013 | | | | | 4,013 | 4,000 |
| Total | | \$ 17,993 | \$ | \$ | \$ | \$ | \$ 17,993 | \$ 17,995 |

Management believes we have the ability to hold the foregoing investments until maturity, and therefore, if held to maturity, we would not expect the future proceeds from these investments to be affected, to any significant degree, by the effect of a sudden change in market interest rates. Declines in interest rates over time will, however, reduce our interest income derived from future investments.

Foreign Currency Exchange Risks

Our Canadian subsidiary's functional currency is the Canadian dollar, which is used to pay labor and other operating costs in Canada. If an arrangement provides for us to receive payments in a foreign currency, revenue realized from such an arrangement may be lower if the value of such foreign currency declines. Similarly, if an arrangement provides for us to make payments in a foreign currency, cost of services and operating expenses for such an arrangement may be higher if the value of such foreign currency increases. For example, a 10% change in the relative value of such foreign currency could cause a related 10% change in our previously expected revenue, cost of services, and operating expenses. If the international portion of our business continues to grow, more revenue and expenses will be denominated in foreign currencies, which increases our exposure to fluctuations in currency exchange rates. Approximately 41.9% of our expenses in the third quarter of 2006 were paid in Canadian dollars. A portion of our U.S. and Canadian operations generate revenues denominated in U.S. dollars. During the third quarter of 2006, we purchased \$20.8 million of Canadian dollars for \$18.5 million U.S. under Canadian dollar forward contracts with Wells Fargo Bank in order to hedge our foreign currency risk with respect to these costs. During the third quarter of 2006, we recorded a gain of approximately \$124 thousand related to these forward contracts. As of September 30, 2006, we had \$76 thousand in derivative assets associated with foreign exchange contracts. As of September 30, 2006, we had contracted to purchase \$3.5 million of Canadian dollars to be delivered periodically through December 2006 at a purchase price which is no more than \$3.1 million and no less than \$2.9 million. We plan to continue to hedge our exposure to fluctuations in the Canadian dollar relative to the U.S. dollar, primarily through the use of forward purchase contracts.

Item 4. Controls and Procedures*Evaluation of disclosure controls and procedures.*

As required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), management, with the participation of our chief executive officer and chief financial officer, evaluated the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Based on this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of September 30, 2006.

Changes in internal controls over financial reporting.

There was no change in our internal control over financial reporting that occurred during the quarter ended September 30, 2006, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents**PART II OTHER INFORMATION****Item 1. Legal Proceedings**

We and six of our present and former directors and officers have been named as defendants in *West Palm Beach Firefighters Pension Fund v. StarTek, Inc., et al.* (U.S. District Court, District of Colorado) filed on July 8, 2005, and *John Alden v. StarTek, Inc., et al.* (U.S. District Court, District of Colorado) filed on July 20, 2005. Those actions have been consolidated by the federal court. The consolidated action is a purported class action brought on behalf of all persons (except defendants) who purchased shares of our common stock in a secondary offering by certain of our stockholders in June 2004, and in the open market between February 26, 2003, and May 5, 2005 (the Class Period). The consolidated complaint alleges that the defendants made false and misleading public statements about us and our business and prospects in the prospectus for the secondary offering, as well as in filings with the Securities and Exchange Commission and in press releases issued during the Class Period, and that the market price of our common stock was artificially inflated as a result. The complaints allege claims under Sections 11 and 15 of the Securities Act of 1933, and under Sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The plaintiffs in both cases seek compensatory damages on behalf of the alleged class and award of attorneys' fees and costs of litigation. We believe we have valid defenses to the claims and intend to defend the litigation vigorously. On May 23, 2006, we and the individual defendants moved the court to dismiss the action in its entirety. Two stockholder derivative lawsuits related to these aforementioned claims were also filed against various of our present and former officers and directors on November 16, 2005, and December 22, 2005, alleging breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, and unjust enrichment. The derivative actions, which have been consolidated, name us as a nominal defendant. On April 18, 2006, we and the individually named defendants filed a motion to dismiss the derivative actions.

It is not possible at this time to estimate the possibility of a loss or the range of potential losses arising from these claims. We may, however, incur material legal fees with respect to our defense of these claims. The claims have been submitted to the carriers of our executive and organization liability insurance policies. The policies have primary and excess coverage that we believe will be adequate to defend this case and are subject to a retention for securities claims. These policies provide that we are responsible for the first \$1.0 million in legal fees. As of November 1, 2006, we had incurred legal fees related to this suit of approximately 80% of our \$1.0 million deductible.

We have been involved from time to time in other litigation arising in the normal course of business, none of which is expected by management to have a material adverse effect on our business, financial condition or results of operations.

Item 1a. Risk Factors

There have been no material changes in our risk factors from those disclosed in our 2005 Annual Report on Form 10-K, except for the addition of the following risk factor:

We may not collect on a \$740 thousand note receivable due from the purchasers of our Supply Chain Management Services platform. On December 16, 2005, we sold our Supply Chain Management Services platform. In connection with the transaction, we accepted a 5-year, unsecured \$740 thousand note. The terms of the note call for the buyer to make quarterly interest payments to us at a fixed rate of 7% per annum for the first two years of the note. Thereafter, the buyer must pay us interest plus set principal amounts, per the terms of the note, with the entire balance due on or before December 16, 2010. The buyer of the Supply Chain Management Services platform is a startup company that commenced operations when the platform was purchased from us. Management actively monitors activity related to this note receivable and regularly assesses the collectibility of the principal and interest payments due. Currently, no allowance has been created to reserve for uncollectible amounts of this note receivable. If, in the future, we must create an allowance or write off uncollectible amounts of this loan, it could have a material effect on our results of operations and financial condition.

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Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of security holders during the quarter ended September 30, 2006. However, certain matters were submitted to a vote during our second quarter. A summary of the results of this vote is included in our Form 10-Q for the quarter ended June 30, 2006.

Item 6. Exhibits

| Exhibit No. | Description |
|-------------|--|
| 10.27 | Compensation for Chairman of the Board (incorporated by reference to Item 1.01 of Form 8-K filed with the Securities and Exchange Commission on August 4, 2006, File No. 1-12793). |
| 31.1 | Certification of Steven D. Butler pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Rodd E. Granger pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Written Statement of the Chief Executive Officer and Chief Financial Officer furnished pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350). |

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Form 10-Q to be signed on its behalf by the undersigned thereunto duly authorized.

| | | |
|----------------------|--|------------------------|
| /s/ STEVEN D. BUTLER | President and Chief Executive Officer (Principal Executive Officer) | Date: November 9, 2006 |
|----------------------|--|------------------------|

Steven D. Butler

| | | |
|---------------------|---|------------------------|
| /s/ RODD E. GRANGER | Executive Vice President and Chief Financial Officer | Date: November 9, 2006 |
|---------------------|---|------------------------|

| | |
|-----------------|---|
| Rodd E. Granger | (Principal Finance and Accounting Officer) |
|-----------------|---|

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Exhibit Index

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