

FRESH BRANDS INC
Form 10-Q
November 17, 2005

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 8, 2005

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 No

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

Yes 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 11, 2005, 4,931,934 shares of Common Stock, \$0.05 par value, were issued and outstanding.

FRESH BRANDS, INC.

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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 8, 2005 | January 1, 2005 |
|---|--------------------|--------------------|
| Current assets: | | |
| Cash and equivalents | \$ 5,576 | \$ 5,870 |
| Receivables, net of allowance for doubtful accounts | 14,228 | 16,098 |
| Inventories | 41,462 | 38,172 |
| Other current assets | 6,425 | 7,038 |
| Deferred income taxes | 5,068 | 5,059 |
| Total current assets | 72,759 | 72,237 |
| Capital sublease receivables | 27,200 | 28,629 |
| Property and equipment | 24,551 | 34,299 |
| Property under capital leases | 27,803 | 39,463 |
| Goodwill | 21,455 | 21,455 |
| Other assets | 11,772 | 6,896 |

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Total assets \$ 185,540 \$ 202,979

Liabilities and Shareholders Investment

Current liabilities:

| | | | | | |
|---|----|--------|--|----|--------|
| Accounts payable | \$ | 32,669 | | \$ | 32,196 |
| Accrued liabilities | | 19,177 | | | 17,619 |
| Current portion of revolving credit facility | | 5,000 | | | 5,000 |
| Current maturities of capital lease obligations | | 2,729 | | | 2,899 |
| Current maturities of long-term debt | | 2,667 | | | 2,968 |

| | | | | |
|---------------------------|--|--------|--|--------|
| Total current liabilities | | 62,242 | | 60,682 |
|---------------------------|--|--------|--|--------|

| | | | | |
|------------------------------|--|--------|--|--------|
| Capital lease obligations | | 68,251 | | 71,322 |
| Revolving credit facility | | 7,800 | | 15,300 |
| Other long-term debt | | 5,605 | | 6,394 |
| Deferred income taxes | | -- | | 602 |
| Other noncurrent liabilities | | 508 | | 480 |
| Minority interests | | 1,273 | | 580 |

Shareholders investment:

| | | | | |
|--|--|----------|--|----------|
| Common stock, \$0.05 par value, authorized 20,000,000 shares, issued 8,750,342 shares as of October 8, 2005 and January 1, 2005 | | 438 | | 438 |
| Additional paid-in capital | | 15,575 | | 15,575 |
| Retained earnings | | 68,927 | | 76,715 |
| Treasury stock at cost, 3,818,408 shares as of October 8, 2005 and 3,822,928 shares as of January 1, 2005 | | (45,079) | | (45,109) |

| | | | | |
|-------------------------------|--|--------|--|--------|
| Total shareholders investment | | 39,861 | | 47,619 |
|-------------------------------|--|--------|--|--------|

| | | | | |
|---|----|---------|--|------------|
| Total liabilities and shareholders investment | \$ | 185,540 | | \$ 202,979 |
|---|----|---------|--|------------|

See notes to condensed consolidated financial statements

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

(In thousands, except per share data)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|--------------------------------------|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Net sales | \$ 160,528 | \$ 154,263 | \$ 522,413 | \$ 513,806 |
| Cost of products sold | 124,711 | 121,087 | 404,992 | 404,928 |
| Gross profit | 35,817 | 33,176 | 117,421 | 108,878 |
| Selling and administrative expenses | 30,762 | 28,471 | 101,247 | 94,110 |
| Repositioning and impairment charges | 14,248 | -- | 15,296 | 2,629 |
| Depreciation and amortization | 2,714 | 2,858 | 9,133 | 9,252 |
| Operating income (loss) | (11,907) | 1,847 | (8,255) | 2,887 |
| Interest expense | 1,007 | 1,018 | 3,456 | 3,243 |

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| | | | | |
|--|------------|---------|------------|------------|
| Minority interest in earnings of consolidated franchises | 437 | 135 | 971 | 199 |
| Income (loss) from continuing operations before income tax | (13,351) | 694 | (12,682) | (555) |
| Income tax provision (benefit) | (5,157) | 95 | (4,894) | (356) |
| Income (loss) from continuing operations | (8,194) | 599 | (7,788) | (199) |
| Loss from discontinued operations, net of tax | -- | (276) | -- | (3,204) |
| Cumulative effect of change in accounting principle | -- | -- | -- | (136) |
| Net income (loss) | \$ (8,194) | \$ 323 | \$ (7,788) | \$ (3,539) |
| Earnings (loss) per basic share: | | | | |
| Income (loss) from continuing operations | \$ (1.66) | \$ 0.12 | \$ (1.58) | \$ (0.04) |
| Loss from discontinued operations | -- | (0.05) | -- | (0.65) |
| Cumulative effect of change in accounting principle | -- | -- | -- | (0.03) |
| Earnings (loss) per basic share | \$ (1.66) | \$ 0.07 | (1.58) | \$ (0.72) |
| Earnings (loss) per diluted share: | | | | |
| Income (loss) from continuing operations | \$ (1.66) | \$ 0.12 | \$ (1.58) | \$ (0.04) |
| Loss from discontinued operations | -- | (0.05) | -- | (0.65) |
| Cumulative effect of change in accounting principle | -- | -- | -- | (0.03) |
| Earnings (loss) per diluted share | \$ (1.66) | \$ 0.07 | (1.58) | \$ (0.72) |
| Weighted average shares and equivalents outstanding: | | | | |
| Basic | 4,932 | 4,927 | 4,931 | 4,917 |
| Diluted | 4,933 | 4,927 | 4,931 | 4,917 |

See notes to condensed consolidated financial statements

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

(In thousands)

| | For the 40-weeks ended | |
|---|------------------------|-----------------|
| | October 8, 2005 | October 9, 2004 |
| Cash flows from operating activities: | | |
| Net loss | \$ (7,788) | \$ (3,539) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Provision for doubtful accounts | 1,113 | 1,900 |
| Depreciation and amortization | 9,133 | 9,376 |
| Provisions for store closures | 1,048 | 4,359 |

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| | | |
|---|-----------------|-----------------|
| Gain on settlement of capital lease obligation | (343) | -- |
| Property and equipment impairment charges | 14,591 | 1,511 |
| Deferred income taxes | (5,340) | (12) |
| Minority interests | 971 | 199 |
| Cumulative effect of change in accounting principles | -- | 136 |
| Changes in assets and liabilities: | | |
| Receivables, net | 773 | (1,282) |
| Inventories | (2,053) | 3,297 |
| Other current assets | 162 | (2,031) |
| Accounts payable | 473 | (7,407) |
| Accrued liabilities | 798 | (2,469) |
| Net cash flows provided by operating activities | 13,538 | 4,038 |
| Cash flows from investing activities: | | |
| Capital expenditures | (1,607) | (4,150) |
| Acquisition of stores by consolidated franchisees, net of cash | (1,578) | -- |
| Proceeds from sale of store | -- | 1,111 |
| Expenditures for land and buildings under development | -- | (1,941) |
| Proceeds from sale of land and buildings under development | -- | 6,776 |
| Receipt of principal amounts under capital subleases | 1,089 | 915 |
| Net cash flows (used for) provided by investing activities | (2,096) | 2,711 |
| Cash flows from financing activities: | | |
| Net change in revolver activity | (7,500) | 1,950 |
| Principal payments on capital lease obligations | (2,898) | (1,956) |
| Principal payments of consolidated franchise debt | (1,441) | (1,926) |
| Principal payments on long-term debt | (184) | (250) |
| Long-term debt proceeds of consolidated franchisees | 535 | -- |
| Deferred financing costs | -- | (512) |
| Distributions to minority interests | (278) | (186) |
| Other financing activities | 30 | 101 |
| Net cash flows used for financing activities | (11,736) | (2,779) |
| Cash and equivalents: | | |
| Net change | (294) | 3,970 |
| Cash of consolidated franchises at beginning of period | -- | 115 |
| Balance, beginning of period | 5,870 | 1,323 |
| Balance, end of period | \$ 5,576 | \$ 5,408 |
| Supplemental cash flow disclosures: | | |
| Interest paid | \$ (3,511) | \$ (3,219) |
| Income taxes refunded, net of payments | 1,595 | 1,500 |
| See notes to condensed consolidated financial statements | | |

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

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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 1, 2005.

Annually, our fiscal year ends on the Saturday closest to December 31. As such, the current fiscal year and the prior fiscal year are both 52-week periods. Consistent with 2004, our first quarter of 2005 is comprised of 16 weeks and the second, third, and fourth quarters are comprised of 12 weeks each.

Certain 2004 amounts have been reclassified to conform to the presentation for 2005.

(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 completed an evaluation of the financial arrangements with our franchisees and concluded that we are required to consolidate certain of these franchisees, primarily as a result of our loan guarantees to these entities. We 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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There are currently 20 franchise entities, which own 22 stores, that are consolidated under FIN 46R. The following table reflects the summarized results of operations for the consolidated franchise entities for the quarterly periods.

(In thousands)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|--|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Retail sales of consolidated franchise entities | \$ 36,147 | \$ 27,511 | \$ 110,586 | \$ 87,842 |
| Operating income of consolidated franchise entities | \$ 431 | \$ 4 | \$ 840 | \$ 120 |
| Interest expense of consolidated franchise entities | 314 | 254 | 1,049 | 886 |
| Net income (losses) of consolidated franchise entities | 117 | (250) | (209) | (766) |
| Less: Minority interest in earnings | 437 | 135 | 971 | 199 |
| Net impact on consolidated income from continuing operations before income taxes | \$ (320) | \$ (385) | \$ (1,180) | \$ (965) |

The following table reflects the summarized balance sheet amounts for the consolidated entities as of October 8, 2005 and January 1, 2005.

(In thousands)

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| | October 8, 2005 | January 1, 2005 |
|---|--------------------|--------------------|
| Current assets | \$ 13,427 | \$ 11,721 |
| Property and equipment, net | 6,076 | 7,094 |
| Property under capital leases, net | 11,569 | 11,986 |
| Goodwill | 1,175 | 1,175 |
| Other noncurrent assets | 213 | 285 |
| Total assets | \$ 32,460 | \$ 32,261 |
| Accounts payable to Fresh Brands | \$ 9,561 | \$ 9,784 |
| Other current liabilities | 4,079 | 3,866 |
| Capital lease obligations to Fresh Brands | 12,247 | 12,415 |
| Notes payable to Fresh Brands | 2,354 | 1,609 |
| Other debt | 7,780 | 8,686 |
| Minority interests | 1,273 | 580 |
| Accumulated deficits | (4,834) | (4,679) |
| Total liabilities and shareholders' investment | \$ 32,460 | \$ 32,261 |

The balances payable to Fresh Brands are eliminated in consolidation. Substantially all of the other long-term debt of these consolidated franchise entities is guaranteed by Fresh Brands.

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(3) Repositioning and Other Impairment Charges

Repositioning and other impairment charges related to continuing operations included the following:

(In thousands)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|--|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Impairment of property and equipment, including capital lease assets | \$ 14,591 | \$ -- | \$ 14,591 | \$ 1,314 |
| Repositioning expenses | -- | -- | 1,048 | 1,315 |
| Gain on settlement of capital lease obligation | (343) | -- | (343) | -- |
| Total repositioning and other impairment charges | \$ 14,248 | \$ -- | \$ 15,296 | \$ 2,629 |

Our corporate retail segment has incurred significant operating losses in last several years primarily resulting from three new stores that were opened in 2003 and January 2004. The pre-tax operating losses for these stores were \$2.7 million in 2003, \$4.0 million in 2004, and \$3.0 million in the year-to-date period for 2005, primarily due to low sales volumes and high facility and labor costs. During the past year, we attempted to significantly improve the sales volumes in these stores through the overall value proposition marketing changes, targeted marketing initiatives for these specific stores, and by seeking to effect in-market consolidation opportunities for these stores. Despite these efforts, in connection with the preparation and review of our financial statements for the quarter ended October 8, 2005, we concluded that we will likely not be able to increase the sales volumes to sustainable levels that would generate sufficient cash flows to recover the carrying value of the long-lived assets, including the capital lease assets, of the stores. Accordingly, we recognized non-cash asset impairment charges totaling \$13,403,000 (\$8.2 million after-tax, or \$1.66 per share) this quarter. Concurrent with our review for long-lived asset impairment, we also completed a review for potential impairment of the goodwill related to the corporate retail segment and determined that no impairment was indicated at October 8, 2005.

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We also have committed to plans for alternate procurement and cross-docking arrangements of the general merchandise processed through our secondary distribution center in Sheboygan, Wisconsin and will be abandoning that leased facility. That decision resulted in an additional non-cash asset impairment charge of \$1,188,000 (\$0.7 million after-tax, or \$0.15 per share).

Impairment charges reflect the difference between the carrying value of the assets and the estimated fair values. We estimate fair values based on a variety of factors including discounted future cash flows for those properties that are not held for sale, estimated market values for equipment, and estimated real estate lease values based on our expectations on the timing of disposition or sublease and the estimated sales price or sublease income associated with the property. These estimates are impacted by a variety of factors including inflation, the general health of the economy, resultant demand for commercial property, the ability to secure subleases, the creditworthiness of sublessees, and our success at negotiating early termination agreements with lessors.

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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 8, 2005.

(In thousands)

| | Balance January 1, 2005 | Provision | Usage | Balance October 8, 2005 |
|-----------------|-------------------------------|-----------------|-----------------|-------------------------------|
| Lease costs | \$ 2,783 | \$ 1,048 | \$ 1,531 | \$ 2,300 |
| Severance costs | 200 | -- | 200 | -- |
| Total | \$ 2,983 | \$ 1,048 | \$ 1,731 | \$ 2,300 |

The provision for lease costs for the 40 weeks ended October 8, 2005 represents the exit costs related to two franchise stores that were closed during the second quarter of 2005. The total repositioning provisions for 2005 and 2004 were charged to our operating segments as follows:

(In thousands)

| | For the 40-weeks ended | |
|------------------------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 |
| Operating segments: | | |
| Wholesale | \$ 1,048 | \$ 1,315 |
| Total continuing operations | 1,048 | 1,315 |
| Discontinued operations | -- | 3,044 |
| Total provision | \$ 1,048 | \$ 4,359 |

The \$343,000 gain on settlement of capital lease obligation in the third quarter of 2005 resulted from the settlement of a capital lease obligation for one of the previously closed corporate stores for less than the estimated net obligation.

(4) Discontinued Operations

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. These operations include one store closed in December 2003, five stores closed in May 2004, and one store sold in August 2004 that we no longer supply.

The following table reflects the components of discontinued operations:

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(In thousands)

| | For 12-weeks ended October 9, 2004 | | For the 40-weeks ended October 9, 2004 | |
|-----------------------------------|--|-------|---|---------|
| Sales | \$ | 1,115 | \$ | 17,524 |
| Loss from operations | \$ | (195) | \$ | (2,243) |
| Loss on disposal | | -- | | (3,044) |
| Operating loss | | (195) | | (5,287) |
| Income tax provision (benefit) | | 81 | | (2,083) |
| Loss from discontinued operations | \$ | (276) | \$ | (3,204) |

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(5) Stock-Based Compensation

We account for stock-based compensation plans under the intrinsic value method in accordance with the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations (*APB Opinion 25*). We have recorded no compensation expense in our 2005 or 2004 condensed consolidated statements of operations.

We have adopted the disclosure requirements of SFAS No. 123. Had we determined compensation cost based on the fair value at the grant date for stock options under SFAS No. 123, our net earnings (loss) would have been reduced (increased) to the following pro forma amounts below:

(In thousands)

| | For the 12-weeks ended October 8, 2005 | | For the 40-weeks ended October 8, 2005 | | For the 12-weeks ended October 9, 2004 | | For the 40-weeks ended October 9, 2004 | |
|--|--|---------|--|------|--|---------|--|---------|
| Net earnings (loss) | | | | | | | | |
| As reported | \$ | (8,194) | \$ | 323 | \$ | (7,788) | \$ | (3,539) |
| Less: Stock-based compensation expense under fair value based method, net of related tax effects | | (46) | | 65 | | (152) | | (218) |
| Pro forma | \$ | (8,240) | \$ | 258 | \$ | (7,940) | \$ | (3,757) |
| Earnings (loss) per share-diluted | | | | | | | | |
| As reported | \$ | (1.66) | \$ | 0.07 | \$ | (1.58) | \$ | (0.72) |
| Pro forma | \$ | (1.67) | \$ | 0.05 | \$ | (1.61) | \$ | (0.76) |

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(6) Long-term Debt and Guarantees

Long-term debt at October 8, 2005 and January 1, 2005 consisted of the following:

(In thousands)

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| | October 8, 2005 | January 1, 2005 |
|--|--------------------|--------------------|
| Revolving credit facility | \$ 12,800 | \$ 20,300 |
| Consolidated franchisee debt | 7,780 | 8,686 |
| Other notes payable, 2.0 to 3.0% interest | 492 | 676 |
| | 21,072 | 29,662 |
| Less amounts classified as current maturities: | | |
| Consolidated franchisee debt maturities | (2,439) | (2,725) |
| Other notes payable maturities | (228) | (243) |
| Current portion of revolving credit facility | (5,000) | (5,000) |
| Long-term debt | \$ 13,405 | \$ 21,694 |

We have a \$40,000,000 revolving credit facility that matures March 18, 2007 and that is secured by substantially all of our assets. The availability under the revolving credit facility is based on a borrowing base formula equal to the sum of 80% of eligible accounts receivable, 60% of eligible inventory, and 60% of eligible owned real estate, less outstanding letters of credit. As of October 8, 2005, net of outstanding letters of credit of \$9,284,000, our available borrowings were \$30,716,000 and our outstanding borrowings were \$12,800,000. While the entire facility remains available for us to borrow, we have classified \$5,000,000 of the October 8, 2005 balance as current based on our expectations to continue to reduce our borrowings under the facility over the next year. Our borrowings throughout 2005 and 2006 will vary based on operating cash flows and the timing of capital expenditures, term debt repayments and seasonal working capital requirements.

The interest rate on borrowings under the revolving credit facility is based, at our option, on either a defined base rate or the London Interbank Offered Rate (LIBOR) plus applicable margins based on a senior debt to cash flow ratio. At October 8, 2005, our borrowing rates were LIBOR plus 1.75% (5.62%) or prime plus 0.25% (6.75%). Commitment fees, ranging from 0.25% to 0.50% per annum, are payable on the average daily unused balance of the revolving credit facility. The revolving credit facility contains various financial covenants including, among others, a fixed charge coverage ratio, a total senior debt cash flow leverage ratio, and a paid sublease ratio. In addition, the revolving credit facility limits our ability to obtain additional debt and incur other liabilities, including capital lease obligations, prohibits us from guaranteeing additional franchisee bank debt, prohibits the payment of cash dividends, and limits our ability to repurchase common stock. At October 8, 2005, we were in compliance with all financial covenants and terms of our revolving credit facility.

The consolidated franchisee debt consists primarily of 13 bank term loans that have interest rates ranging from 3.75% to 7.35% and aggregate monthly principal payments of approximately \$100,000. The loans mature at various dates between November 25, 2005 and July 31, 2008. Fresh Brands, Inc. has guaranteed \$6,183,000 of the consolidated franchisee debt.

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In addition to the guaranteed loans of the consolidated franchisees, we have guaranteed 12 bank loans of other franchisees and certain of their affiliates. These guarantees were made to support the business growth of the franchise and our wholesale operations. The guarantees are for the term of the respective 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 8, 2005 these additional franchise loan balances were \$4,585,000 and our guarantees of those loans were \$3,841,000. Fresh Brands has issued a \$4,000,000 letter of credit in support of its guarantees of both the consolidated franchise and other franchise loans.

Interest expense consisted of the following:

(In thousands)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|--|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Interest on capital lease obligations | \$ 709 | \$ 697 | \$ 2,364 | \$ 2,117 |
| Interest on long-term debt | 161 | 153 | 595 | 592 |
| Amortization of deferred issuance costs | 44 | 53 | 149 | 105 |
| Interest on debt of consolidated franchisees | 109 | 128 | 390 | 467 |

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| | | | | | | | | |
|------------------|----|-------|----|-------|----|-------|----|-------|
| Other | | (16) | | (13) | | (42) | | (38) |
| Interest expense | \$ | 1,007 | \$ | 1,018 | \$ | 3,456 | \$ | 3,243 |

(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 grocery products to our corporate and franchised supermarkets and independent supermarket customers. We supply these products to our supermarkets through two distribution centers in Sheboygan, Wisconsin and through a third-party distribution facility in Milwaukee, Wisconsin. Additionally, we distribute bakery and deli items made in our Platteville, Wisconsin centralized production facility. As of October 8, 2005, our corporate retail business consists of our 20 owned supermarkets and 2 convenience stores. Our retail revenue is generated by our corporate supermarkets selling grocery products to retail consumers. There are currently 20 consolidated franchise entities, which own 22 stores, that comprise the franchise retail segment.

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Summarized financial information for the third quarters and year-to-date periods of 2005 and 2004 concerning our reportable segments is shown in the following tables:

(In thousands)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|---|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Net sales | | | | |
| Wholesale | \$ 111,595 | \$ 108,661 | \$ 365,946 | \$ 371,417 |
| Corporate Retail | 62,946 | 64,692 | 207,270 | 220,847 |
| Franchise Retail | 36,147 | 27,511 | 110,586 | 87,842 |
| Inter-segment eliminations: | | | | |
| Sales to corporate retail | (32,467) | (33,353) | (106,874) | (123,206) |
| Sales to franchise retail | (17,693) | (13,248) | (54,515) | (43,094) |
| Total net sales | \$ 160,528 | \$ 154,263 | \$ 522,413 | \$ 513,806 |
| Income (loss) from continuing operations before income tax | | | | |
| Wholesale | \$ 1,186 | \$ 2,902 | \$ 5,732 | \$ 6,198 |
| Corporate Retail | (13,524) | (1,059) | (14,827) | (3,431) |
| Franchise Retail | 431 | 4 | 840 | 120 |
| Total operating income (loss) | (11,907) | 1,847 | (8,255) | 2,887 |
| Interest expense | 693 | 764 | 2,407 | 2,357 |
| Interest expense of consolidated franchises | 314 | 254 | 1,049 | 886 |
| Minority interest in earnings of consolidated franchises | 437 | 135 | 971 | 199 |
| Income (loss) from continuing operations before income tax | \$ (13,351) | \$ 694 | \$ (12,682) | \$ (555) |

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| | For the 12-weeks ended | | For the 40-weeks ended | |
|--|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Repositioning and impairment charges | | | | |
| Wholesale | \$ 1,188 | \$ -- | \$ 2,236 | \$ 1,315 |
| Corporate Retail | 13,060 | -- | 13,060 | 1,314 |
| Franchise Retail | -- | -- | -- | -- |
| Total Repositioning and Impairment Charges | \$ 14,248 | \$ -- | \$ 15,296 | \$ 2,629 |

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During the second quarter of 2004, in connection with our change in management and the shift in our operational focus to our wholesale operations, we reevaluated our approach to reporting the results of our operating segments and decided to no longer allocate wholesale operating profits to our retail segment. This approach is consistent with how our management reviews the results of operations for our operating units. As a result of this change, we also reassessed the allocation of goodwill that arose in connection with the Dick's Supermarkets acquisition and allocated \$11,495,000 of goodwill to our wholesale segment. Prior year segment information has been restated to conform to the current presentation.

Goodwill at October 8, 2005 and January 1, 2005 for our reportable segments consisted of the following:

(In thousands)

| | October 8, 2005 | January 1, 2005 |
|------------------|--------------------|--------------------|
| Goodwill | | |
| Wholesale | \$ 12,153 | \$ 12,153 |
| Corporate Retail | 8,127 | 8,127 |
| Franchise Retail | 1,175 | 1,175 |
| Total | \$ 21,455 | \$ 21,455 |

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

General

As of October 8, 2005, we owned 20 supermarkets and two convenience stores and franchised an additional 74 supermarkets. This compares to 21 owned supermarkets, two owned convenience stores and 79 franchised supermarkets as of October 9, 2004. Eleven of our corporate supermarkets operate under the Piggly Wiggly® banner and nine of them operate under the Dick's® Supermarkets banner. All of our franchised supermarkets operate 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 northeastern 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 and other products to our corporate and franchised supermarkets and independent retail customers through two distribution centers in Sheboygan, Wisconsin and through a third-party distribution facility in Milwaukee, Wisconsin. Additionally, we distribute items made in our Platteville, Wisconsin centralized bakery/deli production facility to our corporate supermarkets, franchisees, and independent customers.

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Our corporate retail business consists of 20 corporate-owned supermarkets and two convenience stores. Our convenience stores include fuel stations and are located on properties adjacent to our stores. 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 20 franchise entities, which own 22 supermarkets, 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.

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Overview of Impairment Charges

Our corporate retail segment has incurred significant operating losses in last several years primarily resulting from three new stores that were opened in 2003 and January 2004. The pre-tax operating losses for these stores were \$2.7 million in 2003, \$4.0 million in 2004, and \$3.0 million in the year-to-date period for 2005, primarily due to low sales volumes and high facility and labor costs. During the past year, we attempted to significantly improve the sales volumes in these stores through the overall value proposition marketing changes, targeted marketing initiatives for these specific stores, and by seeking to effect in-market consolidation opportunities for these stores. Despite some recent success, in connection with the preparation and review of our financial statements for the quarter ended October 8, 2005, we concluded that we will likely not be able to increase the sales volumes to sustainable levels that would generate sufficient cash flows to recover the carrying value of the long-lived assets, including the capital lease assets, of the stores. Accordingly, we recognized non-cash asset impairment charges totaling \$13.4 million (\$8.2 million after-tax, or \$1.65 per share) this quarter. Concurrent with our review for long-lived asset impairment, we also completed a review for potential impairment of the goodwill related to the corporate retail segment and determined that no impairment was indicated at October 8, 2005. The Board of Directors reviewed our conclusions on October 25, 2005.

We intend to pursue the sale or closure of two of these stores within the first half of 2006 to eliminate the ongoing operating losses that we have been incurring. We anticipate the ultimate disposal of these two stores may benefit future operating results by approximately \$1.3 million annually, or \$0.26 per share. We currently do not intend to close the third store but will further improve operating results by \$0.2 million annually, or \$0.05 per share, due to reduced depreciation and amortization charges.

We also have committed to plans for alternate procurement and cross-docking arrangements of the general merchandise processed through our secondary distribution center in Sheboygan, Wisconsin and will be closing that leased facility. That decision resulted in an additional non-cash asset impairment charge of \$1.2 million (\$0.7 million after-tax, or \$0.15 per share). We expect to improve future operating results by approximately \$0.3 million annually, or \$0.06 per share, through the cross-docking arrangement beginning in the second quarter of 2006.

Depending on the terms of disposal and the settlement of the lease obligations for the two stores and the secondary distribution center, the disposals could result in additional borrowings of approximately \$2.5 million, net of proceeds from the sale of assets at these stores, the liquidation of inventory, and the related tax benefits.

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Results of Operations

The following tables set forth certain selected items from our results of operations for the third quarter and year-to-date periods of 2005 and 2004:

(In thousands, except percentages)

| | For the 12-weeks ended | | For the 40-weeks ended | |
|--------------------------------------|------------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Net sales | \$ 160,528 | \$ 154,263 | \$ 522,413 | \$ 513,806 |
| Gross profit ⁽¹⁾ | 35,817 | 33,176 | 117,421 | 108,878 |
| Repositioning and impairment charges | 14,248 | -- | 15,296 | 2,629 |

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| | | | | |
|---|------------|--------|------------|------------|
| Operating income | (11,907) | 1,847 | (8,255) | 2,887 |
| Income (loss) from continuing operations | (8,194) | 599 | (7,788) | (199) |
| Loss from discontinued operations, net of tax | -- | (276) | -- | (3,204) |
| Cumulative effect of change in accounting principle | -- | -- | -- | (136) |
| Net income (loss) | \$ (8,194) | \$ 323 | \$ (7,788) | \$ (3,539) |

| | | | | |
|-----------------------------|------------|------------|------------|------------|
| Net sales by segment: | | | | |
| Wholesale segment | \$ 111,595 | \$ 108,661 | \$ 365,946 | \$ 371,417 |
| Corporate retail segment | 62,946 | 64,692 | 207,270 | 220,847 |
| Franchise retail segment | 36,147 | 27,511 | 110,586 | 87,842 |
| Inter-segment eliminations: | | | | |
| Sales to corporate retail | (32,467) | (33,353) | (106,874) | (123,206) |
| Sales to franchise retail | (17,693) | (13,248) | (54,515) | (43,094) |

| | | | | |
|-----------|------------|------------|------------|------------|
| Net sales | \$ 160,528 | \$ 154,263 | \$ 522,413 | \$ 513,806 |
|-----------|------------|------------|------------|------------|

| | | | | |
|-------------------------------------|-------------|----------|------------|----------|
| Operating income (loss) by segment: | | | | |
| Wholesale segment | \$ 1,186 | \$ 2,902 | \$ 5,732 | \$ 6,198 |
| Corporate retail segment | (13,524) | (1,059) | (14,827) | (3,431) |
| Franchise retail segment | 431 | 4 | 840 | 120 |
| Operating income | \$ (11,907) | \$ 1,847 | \$ (8,255) | \$ 2,887 |

| | | | | |
|---|------|--|------|--|
| Comparable store sales increases: | | | | |
| Corporate stores | 5.3% | | 2.2% | |
| Consolidated franchise stores | 4.3% | | 2.6% | |
| Other franchise stores ⁽²⁾ | 5.8% | | 4.2% | |
| Combined corporate and franchised stores ⁽²⁾ | 5.4% | | 3.3% | |

- (1) Our gross profits may not be comparable to others in our industry because some entities may include all of the costs related to their distribution network in cost of products sold and others exclude all or a portion of such costs from gross profit, instead including them in an operating expense category such as selling and administrative expenses. Our cost of products sold includes product costs and the production labor in our bakery/deli production facility. Other costs, including purchasing and receiving costs, inspection costs, warehousing costs, internal transfer costs, and other costs of our distribution network are included in our selling and administrative expenses.
- (2) While franchised store sales are not recorded as revenue by us, we believe they are important in understanding our financial performance because their sales volumes generate additional wholesale sales volume and franchise fees and they are indicative of the financial health of our franchise base and the effectiveness of our in-store value proposition.

Wholesale segment

(In thousands, except percentages)

| | For 12-weeks ended | | For the 40-weeks ended | |
|--------------|--------------------|-----------------|------------------------|-----------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Sales | \$ 111,595 | \$ 108,661 | \$ 365,946 | \$ 371,417 |
| Gross profit | 13,145 | 12,292 | 44,748 | 39,254 |
| Gross margin | 11.8% | 11.3% | 12.2% | 10.6% |

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| | | | | |
|--------------------------------------|----------|----------|----------|----------|
| Selling and administrative expenses | 9,845 | 8,477 | 33,659 | 28,886 |
| As a percent of sales | 8.8% | 7.8% | 9.2% | 7.8% |
| Repositioning and impairment charges | 1,188 | -- | 2,236 | 1,315 |
| As a percent of sales | 1.1% | 0.0% | 0.6% | 0.4% |
| Depreciation and amortization | 926 | 913 | 3,121 | 2,855 |
| As a percent of sales | 0.8% | 0.8% | 0.9% | 0.8% |
| Operating income | \$ 1,186 | \$ 2,902 | \$ 5,732 | \$ 6,198 |
| Operating margin | 1.1% | 2.7% | 1.6% | 1.7% |

Wholesale sales increased \$2.9 million, or 2.7%, during the third quarter of 2005 and decreased \$5.5 million, or 1.5%, for the year-to-date period of 2005 compared to the same periods of 2004. The increase in wholesale sales during the third quarter reflected increased sales to our continuing store base consistent with the increased sales throughout the corporate and franchised stores. The decrease in wholesale sales for the year-to-date period primarily reflected the impact of closing three franchise stores and six corporate stores since the first quarter of 2004 and selling one corporate store in August 2004. As a partial offset to these decreases, we added several new wholesale customers during this same time period.

Wholesale operating income has been impacted by several repositioning and impairment charges during 2005 and 2004 including:

Non-cash asset impairment charges of \$1.2 million in the third quarter of 2005 related to our plans to contract alternative procurement and cross-docking arrangements for merchandise processed through our secondary warehouse facility in Sheboygan, Wisconsin.

Lease exit charges of \$1.0 million in the second quarter of 2005 related to the closure of two underperforming franchise stores. A \$1.3 million lease exit charge related to the closure of one franchise store in the first quarter of 2004.

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Our operating income for the quarter and year-to-date periods reflect an improved gross margin and an increased selling and administrative expense rate that were the result of changes to our manufacturer cooperative advertising program and our promotional activities in connection with our implementation of the value proposition strategy. The changes resulted in increased manufacturer allowances and reduced cost of goods, which have been directed at increased merchandise sales, and less income used to offset other advertising costs. As a result of these changes, we also significantly reduced our direct funding of retail promotions.

Our provisions for potentially uncollectible franchise receivables improved to \$0.1 million for the third quarter of 2005 compared to \$0.4 million for the third quarter of 2004 and \$1.1 million for the year-to-date period of 2005 compared to \$1.9 million for the same period in 2004. Each quarter, we estimate the provisions for potentially uncollectible franchise receivables based on a review of the underlying financial performance of the franchisees and our expectations for additional actions that may be taken for underperforming stores. The improvement in the provisions for potentially uncollectible franchise receivables reflect significant improvement in the underlying financial performance of the franchise stores during these periods largely attributable to our value proposition strategy, and we expect the improved performances to continue.

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Corporate retail segment

(In thousands, except percentages)

| | For 12-weeks ended | | For the 40-weeks ended | |
|--------------|--------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Sales | \$ 62,946 | \$ 64,692 | \$ 207,270 | \$ 220,847 |
| Gross profit | 14,601 | 14,758 | 47,994 | 50,679 |

Corporate retail segment

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| | | | | |
|--------------------------------------|-------------|------------|-------------|------------|
| Gross margin | 23.2% | 22.8% | 23.2% | 22.9% |
| Selling and administrative expenses | 13,815 | 14,521 | 45,550 | 48,240 |
| As a percent of sales | 21.9% | 22.4% | 22.0% | 21.8% |
| Repositioning and impairment charges | 13,060 | -- | 13,060 | 1,314 |
| As a percent of sales | 20.7% | 0.0% | 6.3% | 0.6% |
| Depreciation and amortization | 1,250 | 1,296 | 4,211 | 4,556 |
| As a percent of sales | 2.0% | 2.0% | 2.0% | 2.1% |
| Operating income (loss) | \$ (13,524) | \$ (1,059) | \$ (14,827) | \$ (3,431) |
| Operating margin | (21.5)% | (1.6)% | (7.2)% | (1.6)% |

Corporate retail store sales decreased \$1.7 million, or 2.7%, during the third quarter of 2005 and \$13.6 million, or 6.1%, during the year-to-date period of 2005 compared to the same periods of 2004. The decreases were primarily the result of the conversion of two corporate stores in September 2004 to franchise ownership and the closure of one of our Sheboygan area stores in March 2005. Our comparable store sales increases were 5.3% for the quarter and 2.2% for the year-to-date period. These increases reflect substantial increases in our corporate Piggly Wiggly stores as a result of our value proposition strategy and improved weekly promotions during 2005. The increases in our corporate Piggly Wiggly stores were partially offset by a significant decrease in one corporate Dick's Supermarket store due to a new competitive opening, and overall flat sales in our other corporate Dick's Supermarkets stores, in which we have not yet implemented the value proposition.

Corporate retail operating results have been impacted by repositioning and other impairment charges during 2005 and 2004 including:

Non-cash asset impairment charges of \$13.4 million in the third quarter of 2005 related to three underperforming stores.

A \$0.3 million gain in the third quarter of 2005 on the settlement of a capital lease obligation for one of the previously closed corporate stores.

A non-cash asset impairment charge of \$1.3 million recognized in the second quarter of 2004 in connection with the conversion to franchise ownership of two corporate stores.

Our gross profits have improved due to the pricing and marketing efforts commenced in November 2004 that resulted in an enhanced sales mix, such as increased sales of non-promoted items and increased sales in our perishable departments that generally have higher gross margins.

Sales and operating losses for the two stores that we intend to dispose were \$13.6 million and \$1.9 million, respectively, for the 40-week period ended October 8, 2005

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Franchise retail segment

(In thousands, except percentages)

| | For 12-weeks ended | | For the 40-weeks ended | |
|-------------------------------------|--------------------|--------------------|------------------------|--------------------|
| | October 8, 2005 | October 9, 2004 | October 8, 2005 | October 9, 2004 |
| Sales | \$ 36,147 | \$ 27,511 | \$ 110,586 | \$ 87,842 |
| Gross profit | 8,576 | 6,613 | 26,385 | 20,998 |
| Gross margin | 23.7% | 24.0% | 23.9% | 23.9% |
| Selling and administrative expenses | 7,567 | 6,056 | 23,609 | 19,037 |
| As a percent of sales | 20.9% | 22.0% | 21.3% | 21.7% |
| Depreciation and amortization | 578 | 553 | 1,936 | 1,841 |
| As a percent of sales | 1.6% | 2.0% | 1.8% | 2.1% |
| Operating income | \$ 431 | \$ 4 | \$ 840 | \$ 120 |
| Operating margin | 1.2% | 0.0% | 0.8% | 0.1% |

Our franchise retail segment is comprised of the franchise entities that we are required to consolidate with our own operations primarily because of loans or loan guarantees to these entities and their financial condition at the time the loans or loan guarantees were made. Our operating results for the third quarter of 2005 include the results of 22 consolidated franchise stores and the operating results for the third quarter of 2004 include the results for 16 consolidated franchise stores. With continued improvement in operating performance, we believe these entities can be financially independent entities in the long-term.

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Franchise retail sales for the third quarter of 2005 increased \$8.6 million, or 31.4%, compared to the third quarter of 2004. The increase was primarily due to the six additional stores included in this consolidated group. Sales of comparable stores increased 4.3% for the third quarter and increased 2.6% for the year-to-date period as a result of the pricing and marketing efforts commenced in November 2004. Operating income and margins for the consolidated franchise stores have improved based on the increased sales volumes, the improved sales mix from the value proposition initiative, and the management of operational expenses.

Additional sales increases are needed to improve the operating results of certain stores within the franchise retail segment and our focus is on plans to assist the franchisees to do so. Subject to local market competitive conditions and industry factors, we believe the operating results for these franchise entities may continue to improve over time with further sales growth and the continued close management of operational expenses.

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Interest Expense

Interest expense increased primarily due to the interest on the capital lease obligation for the new bakery/deli production facility.

Income Tax Provision

Our effective tax benefit rate for loss from continuing operations was 38.6% for 2005 and 64.1% for 2004.

Discontinued Operations

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

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Liquidity and Capital Resources

Summary

We have a \$40,000,000 revolving credit facility that matures on March 18, 2007 and that is secured by substantially all of our assets. The availability under the revolving credit facility is based on a borrowing base formula equal to the sum of 80% of eligible accounts receivable, 60% of eligible inventory, and 60% of eligible owned real estate, less outstanding letters of credit. As of October 8, 2005, net of outstanding letters of credit of \$9,284,000, our available borrowing capacity was \$30,716,000 and our outstanding borrowings were \$12,800,000. While the entire facility remains available for us to borrow, we have classified \$5,000,000 of the October 8, 2005 balance as current based on our expectations to continue to reduce our borrowings under the facility over the next year. Our borrowings throughout 2005 and 2006 will vary based on operating cash flows and the timing of capital expenditures, term debt repayments and seasonal working capital requirements. We believe that our cash flow from operations and availability under our revolving credit facility will be sufficient to meet our normal expected working capital requirements, planned capital expenditures, and term debt payments for 2005 and 2006.

The interest rate on borrowings under the revolving credit facility is based, at our option, on either a defined base rate or the London Interbank Offered Rate (LIBOR) plus applicable margins based on a senior debt to cash flow ratio. At October 8, 2005, our borrowing rates were LIBOR plus 1.75% (5.62%) or prime plus 0.25% (6.75%). Commitment fees, ranging from 0.25% to 0.50% per annum, are payable on the average daily unused balance of the revolving credit facility. The revolving credit facility contains various financial covenants including, among others, a fixed charge coverage ratio, a total senior debt cash flow leverage ratio, and a paid sublease ratio. In addition, the revolving credit facility limits our ability to obtain additional debt and incur other liabilities, including capital lease obligations, prohibits us from guaranteeing additional franchisee bank debt, prohibits the payment of cash dividends, and limits our ability to repurchase common stock.

At October 8, 2005, we were in compliance with all financial covenants and terms of our revolving credit facility. The following table summarizes our ratios under the key financial covenants:

| Financial Covenant ⁽¹⁾ | Required Ratio | Ratio as of October 8, 2005 | Ratio as of January 1, 2005 |
|-----------------------------------|----------------|--------------------------------|--------------------------------|
|-----------------------------------|----------------|--------------------------------|--------------------------------|

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| | | | |
|---|---------------------|--------|--------|
| Fixed Charge Coverage Ratio ⁽²⁾ | At least 1.25:1 | 4.11:1 | 5.01:1 |
| Total Senior Debt Cash Flow Leverage Ratio ⁽³⁾ | No more than 2.00:1 | 1.31:1 | 1.48:1 |
| Paid Sublease Ratio ⁽⁴⁾ | At least 0.90:1 | 0.97:1 | 0.98:1 |

- (1) Each of these ratios is defined in our revolving credit agreement.
- (2) Our Fixed Charge Coverage Ratio is a measure of our cash flow compared to our fixed charges.
- (3) Our Total Senior Debt Cash Flow Leverage Ratio is a measure of our senior debt compared to our cash flow.
- (4) Our Paid Sublease Ratio is a measure of the number of our franchisees who sublease their stores from us who are current on their rent payments.

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The following tables summarize our cash flow during the year-to-date periods of 2005 and 2004 (in thousands):

| | 2005 | 2004 |
|--|----------|----------|
| Cash and cash equivalents at beginning of year | \$ 5,870 | \$ 1,323 |
| Cash provided by operating activities | 13,538 | 4,038 |
| Cash provided by (used in) investing activities | (2,096) | 2,711 |
| Cash provided by (used in) financing activities | (11,736) | (2,779) |
| Cash of consolidated franchises at beginning of period | -- | 115 |
| Cash and cash equivalents at end of period | \$ 5,576 | \$ 5,408 |

Cash Flows From Operating Activities

Cash provided by operating activities was \$13.5 million in 2005 compared to \$4.0 million in 2004. This increase was primarily the result of improved operating results and improved collections of trade receivables, offset in part by a \$2.1 million increase in inventories. Cash provided by operating activities before changes in operating assets and liabilities was \$13.4 million in 2005 and \$13.9 million in 2004.

Cash Flows From Investing Activities

Our aggregate capital expenditures were \$1.6 million through the third quarter of 2005, compared to \$4.2 million for 2004. We anticipate that we will spend approximately \$1.3 million in the fourth quarter of this year. Through the third quarter of 2005, we spent approximately \$0.7 million for the implementation of our retail pricing technology that will allow us to more strategically manage competitive prices and ultimately enhance our gross margins. We expect to spend an additional \$0.3 million prior to year end as we continue with our implementation. We spent approximately \$0.4 million for remodeling and maintaining our corporate stores through the third quarter of 2005 and we expect to spend an additional \$0.6 million during the fourth quarter. After a thorough review of upgrade needs, and the utilization of equipment from previously closed stores, we were able to significantly reduce the capital expenditure requirements related to store upgrades for our Dick's Supermarket stores. Our remaining capital expenditures principally related to projects to maintain our distribution centers and other technology related projects.

We have used sale and leaseback arrangements to finance substantially all of our retail facility projects. Under these arrangements, we capitalize the costs incurred for land and buildings under development until project completion. Upon completion, the facilities are sold and lease arrangements are established. In the first quarter of 2004, we completed the sale and leaseback for the corporate store opened in January 2004 and we were reimbursed for some interim funding related to the replacement bakery/deli production facility. We currently have no further commitments for any additional new or replacement facilities.

Cash Flows From Financing Activities

Cash used for financing activities primarily reflects net borrowing or repayments under our revolving credit facility, and payments of capital lease obligations and term debt. During 2005, we used cash to reduce our borrowings under our revolving credit facility by \$7.5 million

and to pay \$4.5 million in capital lease obligations and term debt. In 2004, we paid \$4.1 million for capital lease obligations and term debt and increased our borrowings under our revolving credit facility by \$2.0 million. Due to credit facility restrictions, and our focus on reducing our debt, we do not currently anticipate paying any dividends or making any additional repurchases under our stock repurchase plan during 2005.

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Special Note Regarding Forward-Looking Statements

Certain matters discussed in this filing, particularly in the section titled "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations," are forward-looking statements intended to qualify for the safe harbors from liability established by the Private Securities Litigation Reform Act of 1995. These forward-looking statements can generally be identified as such because the context of the statement will include words such as we believe, anticipate, expect or words of similar import. Similarly, statements that describe our future plans, objectives, strategies or goals are also forward-looking statements. Specifically, forward-looking statements include statements about: (a) our expectations regarding the anticipated benefits of our new operational focus, particularly our new in-store value proposition and pricing and marketing strategy, including the impact that they will have on our future financial performance and condition, including on our net sales and gross profit margins and comparable store sales; (b) the anticipated benefits that our new in-store value proposition and specific marketing plans and other operating goals will have on our underperforming corporate and franchised supermarkets and the potential consequences if such anticipated benefits are not realized; (c) the number of expected owned and franchisee supermarket closings in 2005, the amount of charges we expect to incur in connection with such supermarket closings and the potential effect that such charges could have on our future financial performance and condition; (d) the annual savings that we expect to realize as a result of our full integration of our Dick's Supermarkets operations; (e) the anticipated impact that our new headquarters pricing system will have on our pricing strategy; (f) our ability to continue to grow our wholesale operations; (g) our belief that our existing bank credit facility will provide us with sufficient liquidity to meet our normal, expected working capital requirements, planned capital expenditures, and term debt payments for 2005; and (h) the potential that we may incur impairment charges for goodwill and the potential magnitude of such charges. Such forward-looking statements are subject to certain risks and uncertainties that may materially adversely affect our anticipated results. Such risks and uncertainties include, but are not limited to, the following: (1) our realizing the expected benefits of our new in-store value proposition and the likely material adverse consequences to our financial results and condition if they are not realized or not realized in a timely manner; (2) the possibility that the our vendors may adversely change the terms on which they extend credit to sell us products; (3) our limited liquidity under our revolving credit facility; (4) our significant capitalized lease and guarantee amounts; (5) the presence of intense competitive market activity in our market areas, including competition from warehouse club stores and deep discount supercenters; (6) the cost advantages that many of our competitors have as a result of their larger purchasing power and, in many cases, non-union workforces; (7) our ability to identify and convert new franchisee stores; (8) our continuing ability to obtain reasonable vendor marketing funds for promotional purposes; (9) the potential recognition of repositioning and/or other charges resulting from potential closures, conversions and consolidations of retail stores due principally to the competitive nature of the industry and to the quality of our retail store operators; (10) the potential recognition of additional charges relating to uncollectible accounts receivable from our franchise operators; (11) the potential recognition, if we are not able to achieve our operating plans for certain of our corporate retail stores, of additional potentially significant impairment charges for goodwill; and (12) our costs to continue to comply with the Sarbanes-Oxley Act of 2002. Shareholders, potential investors and other readers are urged to consider these risks carefully in evaluating the forward-looking statements made herein and are cautioned not to place undue reliance on such forward-looking statements. The forward-looking statements made herein are only made as of the date of this quarterly report on Form 10-Q and we disclaim any obligation to publicly update such forward-looking statements to reflect subsequent events or circumstances.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

Our only variable rate financial instrument subject to interest rate risk is our revolving credit facility, which permits borrowings at interest rates based on either the bank's prime rate or adjusted LIBOR. As a result of the amounts owed pursuant to our revolving credit facility, increases in market interest rates would cause our interest expense to increase and our earnings from continuing operations before income taxes to decrease. Based on our credit facility borrowings as of October 8, 2005, a 100 basis point increase in market interest rates would increase our annual interest expense by approximately \$128,000. Similarly, a 100 basis point decrease in the market interest rate would reduce our annual interest expense by approximately \$128,000.

We believe that our exposure to other market risks including risks related to changes in foreign currency exchange rates, commodity prices, equity prices, and trade accounts receivable is not significant.

Item 4. Controls and Procedures

a. Evaluation of disclosure controls and procedures:

Based on their respective evaluations as of the end of the fiscal quarter to which this Quarterly Report on Form 10-Q relates, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934 (the "Exchange Act")) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

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b. Changes in internal control over financial reporting:

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(b) of the Exchange Act that occurred during the fiscal quarter to which this quarterly report relates that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II OTHER INFORMATION

Item 2. Changes in Securities and Use of Proceeds

In January 1992, our board of directors instituted a share repurchase plan. Since then, the aggregate amount of our common stock that we can repurchase pursuant to this plan has been increased several times, most recently to its current \$30.0 million limit. During the quarter ended October 8, 2005, we did not repurchase any shares of our common stock. Although the plan does not have any expiration date, due to credit facility restrictions, and our focus on reducing our debt, we do not currently anticipate making significant additional repurchases under this plan during 2005.

Pursuant to covenants in our revolving credit facility, we are prohibited from paying cash dividends on our common stock and are limited in our ability to repurchase our common stock.

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Item 6. Exhibits

- 31.1 Certification by the Principal Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification by the Principal Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32 Certifications of Periodic Financial Report by the Principal Executive Officer and Principal Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

FRESH BRANDS, INC.

Dated: November 17, 2005

By: /s/ Louis E. Stinebaugh
Louis E. Stinebaugh,
President and Chief Operating Officer

Dated: November 17, 2005

By: /s/ John H. Dahly
John H. Dahly,
Executive Vice President, Chief Financial Officer,
Secretary and Treasurer

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