

1 800 CONTACTS INC
Form 10-K
March 28, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-K

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

For the fiscal year ended December 28, 2002 or

o **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: 0-23633

1-800 CONTACTS, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

87-0571643

(I.R.S. Employer Identification No.)

66 E. Wadsworth Park Drive 3rd Floor, Draper, UT

(Address of principal executive offices)

84020

(Zip Code)

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(801) 924-9800

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Not applicable

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

Common Stock, par value \$.01 per share

(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Yes No

The aggregate market value of voting common equity held by non-affiliates of the registrant as of June 29, 2002 at a closing sale price of \$13.49 as reported by the Nasdaq National Market (Nasdaq) was approximately \$74 million. Shares held by each officer and director and by each person who owns or may be deemed to own 10% or more of the outstanding Common Stock have been excluded since such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

As of March 17, 2003, the Registrant had 13,029,760 shares of Common Stock, par value \$0.01 per share, outstanding.

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Documents Incorporated by Reference

Portions of the Registrant's Proxy Statement to be used in connection with the solicitation of proxies for the Annual Meeting of Stockholders to be held on May 16, 2003 (the "Proxy Statement") are incorporated by reference in Part III of this Annual Report on Form 10-K (the "Form 10-K").

1-800 CONTACTS, INC.

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PART I

Item 1. Business.

Overview

1-800 CONTACTS, INC. (the Company) was incorporated under the laws of the State of Utah in February 1995 and was reincorporated under the laws of the State of Delaware in February 1998 in conjunction with its initial public offering of common stock. The Company is the successor to the business founded by the Company's Vice President of Sales in March 1991. The Company's principal executive office is located at 66 E. Wadsworth Park Drive, 9th Floor, Draper, Utah 84020, and its telephone number is (801) 924-9800. The Company maintains a website on the Internet at www.1800contacts.com. The Company provides on this website, free of charge, periodic and current reports as soon as is reasonably practicable after such material is furnished to the SEC.

The Company is a leading direct marketer of replacement contact lenses. As of December 28, 2002, the Company had shipped more than 8.0 million orders to more than 2.5 million customers since inception. Through its easy-to-remember, toll-free telephone number, 1-800 CONTACTS (1-800-266-8228), and through its Internet addresses, which include www.1800contacts.com, www.contacts.com and www.contactlenses.com, the Company sells all of the popular brands of contact lenses, including those manufactured by Johnson & Johnson, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company's high volume, cost-efficient operations, supported by its proprietary management information systems, enable it to offer consumers an attractive alternative for obtaining replacement contact lenses in terms of convenience, price, speed of delivery and customer service. As a result of its extensive inventory of more than 35,000 SKUs, the Company generally ships approximately 94% of its orders within one business day of receipt. The Company believes that it offers its customers an attractive alternative for obtaining replacement contact lenses in terms of convenience, price, speed of delivery and customer service.

The Company's Internet sales channel continued to grow in fiscal 2002 and is a more cost-effective way for the Company to serve its customers. The Company's Internet sales for fiscal 2002 were \$70.7 million, or 42% of total sales, compared to \$67.6 million, or 40% of total sales, in the previous fiscal year. Its online presence enables the Company to operate more efficiently by substantially eliminating the payroll and long distance costs associated with telephone orders. This increased efficiency allows the Company to offer Internet customers free shipping in addition to other services such as e-mail shipping confirmation, online order tracking and e-mail correspondence.

The Company markets its products through a national advertising campaign that aims to increase recognition of the 1-800 CONTACTS brand name, increase traffic on its website, add new customers, continue to build strong customer loyalty and maximize repeat purchases. As compared to other direct marketers of replacement contact lenses, the Company believes that its toll-free telephone number and Internet addresses afford it a significant competitive advantage in generating consumer awareness and repeat business. The Company spent approximately \$12.6 million on advertising in fiscal 2002 and has invested more than \$110 million in its national advertising campaign over the last several years. The Company's experience has been that increases in advertising expenditures have a direct impact on the growth of net sales.

On July 24, 2002, the Company completed the acquisition of certain net assets and the majority of the business operations of IGEL, a developer and contract manufacturer of contact lenses based in Singapore. The acquisition was effected through a wholly owned subsidiary of the Company, IGEL Acquisition Co. Pte Ltd (subsequently renamed ClearLab Pte Ltd). ClearLab manufactures injection cast molded soft contacts lenses on a contract basis for various contact lens manufacturers. ClearLab also manufactures and distributes branded and private label contact lenses via distributors and other sales channels. ClearLab currently has the capacity to produce in excess of 40 million lenses annually, which is enough to service approximately one million two-week disposable contact lens wearers. ClearLab is in the process of designing and

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developing a new brand of contact lens that will provide the Company increased control of production and inventory and the flexibility to make a variety of offers to its customers to enhance its capability to provide high quality, cost-effective products. ClearLab's net sales for fiscal 2002 from the date of acquisition were \$2.1 million, representing 1.2% of the Company's consolidated net sales.

For more information regarding recent transactions by the Company, see Management's Discussion and Analysis of Financial Condition and Results of Operations - Recent Transactions.

Industry Overview

Industry analysts estimate that over 50% of the United States population need some form of corrective eyewear. Contact lenses are a convenient, cost-effective alternative to eyeglasses. The number of contact lens wearers is expected to increase as technology further improves the convenience, comfort and fit of contact lenses. As a result, the contact lens market is large and growing. The growth in the disposable market is largely due to the shift in the contact lens market away from traditional soft lenses, which generally are replaced on an annual basis, to disposable lenses, which are generally replaced on a daily, weekly, or bi-weekly basis.

Traditionally, contact lenses were sold to consumers almost exclusively by either ophthalmologists or optometrists (referred to herein collectively as eye care practitioners). Eye care practitioners would typically supply a patient with his or her initial pair of contact lenses in connection with providing the patient an eye examination and subsequently provide replacement lenses, regardless of whether the patient was given or required another eye examination. Because the initial fitting of contact lenses requires a prescription written by an eye care practitioner, the initial sale of contact lenses still takes place primarily in this manner. Over the last two decades, however, a number of alternative sellers of replacement contact lenses have emerged, including direct marketers.

The Company believes that increased consumer awareness of the benefits of the direct marketing of contact lenses will lead to further growth of this method of buying and selling contact lenses. Purchasing replacement contact lenses from a direct marketer offers the convenience of shopping at home, rapid home delivery, quick and easy telephone or Internet ordering and competitive pricing. In addition, the growth in popularity of disposable contact lenses, which require patients to purchase replacement lenses more frequently, has contributed to the growth of the direct marketing channel. The direct marketing industry continues to grow as many retail customers have migrated towards the convenience and service offered by home shopping. The Company expects the direct marketing segment of the contact lens industry to grow in tandem with the growth in the direct marketing industry as a whole.

The Company believes that the growth and acceptance of the Internet presents significant opportunities for direct marketers of contact lenses such as the Company. The factors driving this growth include the increasing number and decreasing cost of personal computers in homes and offices, technological innovations providing easier, faster and cheaper access to the Internet, the proliferation of content and services being provided on the Internet and the increasing use of the Internet by business and consumers as a medium for conducting business.

The Internet possesses a number of unique and commercially powerful characteristics that differentiate it from traditional media: users communicate or access information without geographic limitations; users access dynamic and interactive content on a real-time basis; and users communicate and interact instantaneously. The Internet has created a dynamic and particularly attractive medium for commerce, empowering customers to gather more comparative purchasing data than is feasible with traditional commerce systems, to shop in a more convenient manner and to interact with sellers in many new ways. The Company believes that the Internet provides a convenient and efficient medium for the sale of replacement contact lenses.

Historically, sales of contact lenses by direct marketers have been impeded by eye care practitioners and contact lens manufacturers. Many eye care practitioners have been reluctant to provide patients with a copy of their prescription or to release such information to direct

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marketers upon request, thereby impeding patients from purchasing lenses from a direct marketer. Until recently, substantially all of the major manufacturers of contact lenses refused to sell contact lenses directly to direct marketing companies and sought to prohibit their distributors from doing so. These traditional barriers to the direct marketing of contact lenses have been reduced and may be completely eliminated in the future. The Federal Trade Commission (the "FTC") has from time to time solicited comments regarding whether eye care practitioners should be required to release contact lens prescriptions to their patients. See "Purchasing and Principal Suppliers" and "Government Regulation."

Product Offerings

Contact lenses can be divided into two categories: soft lenses and hard lenses (primarily rigid gas permeable). There are three principal wearing regimes for soft contact lenses: conventional, disposable and planned replacement. Conventional lenses are designed to be worn indefinitely but are typically replaced after 12 to 24 months. Disposable soft contact lenses were introduced in the late 1980s based on the concept that changing lenses on a more regular basis was important to comfort, convenience, maintaining healthy eyes and patient compliance. Disposable lenses are changed as often as daily and up to every two weeks, depending on the product. Planned replacement lenses are designed to be changed as often as every two weeks and up to every three months.

The Company is a direct marketer of replacement contact lenses and does not provide eye examinations or related services to its customers. The Company offers substantially all of the soft and hard contact lenses produced by the leading contact lens manufacturers, including Johnson & Johnson, CIBA Vision, Bausch & Lomb, Ocular Sciences and CooperVision. The Company stocks a large inventory of lenses from which it can ship approximately 94% of its orders within one business day of receipt. The Company believes that its ability to maintain a large inventory of contact lenses provides it with a competitive advantage over eye care practitioners, optical chains and discount stores and serves as an effective barrier to entry to potential entrants in the direct marketing of contact lenses.

The Company purchases product directly from certain manufacturers, including Johnson & Johnson, CIBA Vision, Bausch & Lomb, and CooperVision. See Purchasing and Principal Suppliers. The Company's products are delivered in the same sterile, safety sealed containers in which the lenses were packaged by the manufacturer. From time to time, the Company purchases contact lenses that were labeled as samples by the manufacturer. Such lenses are sometimes offered by the Company to customers as part of promotional programs at reduced prices.

The Company's wholly owned subsidiary, ClearLab, manufactures injection cast molded soft contact lenses on a contract basis for various contact lens manufacturers. ClearLab also manufactures and distributes branded and private label contact lenses via distributors and other sales channels. ClearLab currently manufactures disposable lenses, focusing mainly on two-week disposable lenses. ClearLab is in the process of designing and developing a new brand of disposable contact lens that will provide the Company increased control of production and inventory and the flexibility to make a variety of offers to its customers to enhance its capability to provide high quality, cost-effective products. The Company expects to begin marketing lenses made by ClearLab to its customers in the second quarter of fiscal 2003.

The Company also offers certain products related to contact lenses including solutions and lens cases for storing contact lenses. The Company offers solutions produced by CIBA Vision and purchased directly from CIBA Vision. The lens cases are produced by and purchased from an outside party on a contract basis.

Customers and Marketing

The Company's direct marketing customers are located principally throughout the United States. The percentage of the Company's customers that are located in each state is approximately equal to the percentage of the United States' population which resides in such state, with the largest concentration of the Company's customers residing in California. The Company strives to deliver a high level of customer service in an effort to maintain and expand its loyal customer base. The Company utilizes a focused marketing strategy that is designed to enhance the awareness and value of its brand. The Company continually researches and analyzes new ways in which to advertise its products. After identifying an attractive potential new advertisement or advertising medium, the Company commits to such advertising for an initial test period.

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After the initial testing period, the Company continues to closely monitor its advertising in order to identify and react to trends and patterns as appropriate.

The majority of contact lens wearers are between the ages of 14 and 49. In addition, approximately two-thirds of contact lens wearers are women and contact lens wearers generally have higher incomes than eyeglass wearers do. Through its national advertising campaign, the Company is able to target its advertising to contact lens wearers in these key demographic groups, as well as certain other persons based on other important demographics.

The Company spent approximately \$12.6 million on advertising in fiscal 2002. During 2002, the Company

decreased its annual investment in advertising as part of the Company's ongoing effort to manage demand for Johnson & Johnson products in response to Johnson & Johnson's refusal to sell to the Company. In December 2002, the Company announced that it reached an agreement with Johnson & Johnson's eye care division, Vistakon, to become an authorized retailer of Vistakon contact lenses. The Company began buying directly from Vistakon during March 2003. The Company intends to increase advertising spending in fiscal 2003 as it continues its nationwide advertising campaign. The Company's advertising campaign targets both its traditional telephone customers and its online customers and is designed to drive new and repeat purchases. In addition, the Company intends to continue its direct marketing campaign to its more than 2.5 million customers through the U.S. mail and e-mail.

A brief description of the principal components of the Company's national advertising campaign is set forth below:

Broadcast. The Company utilizes a nationwide broadcast advertising campaign with significant purchases on both cable and network television. The Company's television ads typically focus on its ability to rapidly deliver to customers the same contact lenses offered by eye care practitioners. The Company believes that its easy-to-remember phone number and Internet address make television a particularly effective marketing vehicle and that television advertising will continue to be the key to building awareness for its 1-800 CONTACTS brand name.

Internet. The Company uses the unique resources of the Internet as a means of marketing in an effort to drive new and repeat traffic. The Company continues to seek opportunities to expand its presence within highly trafficked content sites.

Direct-Mailing. The Company uses direct-mail to advertise its products to selected groups of consumers. The Company utilizes mailing lists obtained from both private and public sources to target its advertisements specifically to contact lens wearers.

Cooperative Mailings. The Company advertises its products in cooperative mail programs sponsored by the leading cooperative mail companies in the United States. This advertising medium permits the Company to target consumers in specific zip codes according to age, income and other important demographics.

The Company intends to begin marketing lenses made by ClearLab to its customers in the second quarter of fiscal 2003. In fiscal 2001, the Company tested whether it could successfully transition its customers into new products by assisting them in getting fitted for a new brand of contact lenses. The Company believes that these tests indicate that its customers are receptive to an offer from the Company to try both a new product and a new eye care practitioner. The Company feels that a more active role in the product/provider decision may help it address the policies of certain manufacturers that continue to refuse to sell their brands to the Company and seek to sell their brands exclusively to eye care practitioners. The Company's first preference is to sell the customer the lens she is already wearing. In cases where manufacturers or eye care practitioners stand in the way of the customer's choice to purchase from the Company, the Company will be able to offer the customer the opportunity to try an alternative eye care provider and an alternative product.

ClearLab's customers include various contact lens manufacturers and distributors. ClearLab currently manufactures two-week disposable lenses for one of the leading contact lens manufacturers.

Management Information Systems

The Company has developed proprietary management information systems that integrate the Company's order entry and order fulfillment operations. The Company is continually upgrading and enhancing these systems and believes that these systems enable it to operate efficiently and provide enhanced customer service. The key features of these management information systems are their ability to: (i) process numerous types of orders, including telephone, Internet and others; (ii) continually monitor and track the Company's inventory levels for substantially all of its products; (iii) rapidly process credit card orders; (iv) increase the speed of the shipping process with integrated and automated shipping

functions; and (v) increase accuracy through the scanning of each order prior to shipment to ensure it contains the correct quantity and type of lenses.

The management information systems provide the Company's customer service representatives (CSRs) with real-time product availability information for substantially all of its products through a direct connection with the Company's distribution center, whereupon information is immediately updated as lenses are shipped. In addition, Internet customers can obtain real-time product availability information for many products. The management information systems also have an integrated direct connection for processing credit card payments which allows the CSR to charge the customer's card and ensure that a valid card number and authorization have been received in approximately five seconds while the CSR is on the phone with the customer. CSRs also have access to records of all prior contact with a customer, including the customer's address, prescription information, order history and payment history and notes of any prior contact with the customer made by phone, Internet, e-mail, mail or fax. Based on product availability provided by the management information systems, the CSR provides the customer with an estimated date of delivery of their lenses. If a customer's order will not be shipped by the promised delivery date, the management information systems notify the CSR who entered the order and provide any information explaining the delay, and the CSR contacts the customer to inform them of the delay.

After an order has been entered into the management information systems by a CSR, it is sent to the Company's distribution center via a direct connection. After the distribution center receives the order, the invoice for the order is printed. The invoice for each order contains the type and quantity of the lenses, as well as a shipping label for the order. Tracking, manifesting, billing and other shipping functions are integrated into the Company's management information systems so that all necessary bar codes and tracking information for shipment via independent couriers are printed directly on the Company's shipping label, and separate labeling or a separate computer is not needed to ship packages via independent couriers.

After the invoice for an order is printed at the Company's distribution center, the order is pulled from inventory and scanned to ensure that the prescription and quantity of each item matches the order in the Company's management information systems. Audible notices inform the shipping agent of any errors in the order. After the order has been scanned for accuracy, the management information systems update the Company's inventory level. Then the order is placed in a box produced by the Company's automated box folder and is sent to an automatic sealer. After the package leaves the sealer, another scanner reads the bar code on the shipping label to determine which method of shipment is being used, adds the package to the appropriate carrier's manifest and directs the appropriate hydraulic diverter to push the package into the appropriate carrier's shipping bin.

The Company has installed a battery powered back-up system capable of supporting its entire call center, computer room and phone switch. This system is further protected by a generator capable of supporting the Company's call center operations for a period of five days. All critical data is simultaneously written to a series of back-up drives throughout the day and at the end of the day the Company's data is transmitted to an offsite location. There can be no assurance that the Company's back-up system will be sufficient to prevent an interruption in the Company's operations in the event of disruption in the Company's management information systems, and an extended disruption in the management information systems could adversely affect the Company's business, financial condition and results of operations.

Operations

Direct Marketing

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The primary components of the Company's direct marketing operations include its teleservices, order entry and customer service, Internet and distribution and fulfillment.

Teleservices, Order Entry and Customer Service. The Company provides its customers with toll-free telephone access to its CSRs. Currently, the Company's call center generally operates from 6:00 a.m. to 10:00 p.m. (MST) Monday through Thursday, 6:00 a.m. to 9:00 p.m. (MST) on Friday, 7:00 a.m. to 9:00 p.m. (MST) on Saturday and 8:00 a.m. to 4:00 p.m. (MST) on Sunday. Customers may place orders via the Internet 24 hours a day, 7 days a week.

Potential

customers may also obtain product, pricing or other information over the Internet or through an interactive voice response system. The Company's orders are received by phone, Internet, mail, facsimile and electronic mail. CSRs process orders directly into the Company's proprietary management information systems, which provide customer order history and information, product specifications, product availability, expected shipping date and order number. CSRs are provided with a sales script and are trained to provide information about promotional items. Additionally, CSRs are trained to provide customer service and are authorized to resolve all customer service issues, including accepting returns and issuing refunds, as appropriate.

The Company believes its customers are particularly sensitive to the way merchants and salespeople communicate with them. The Company strives to hire energetic, service-oriented CSRs who can understand and relate to customers. CSRs participate in an extensive training program. The Company also has a quality assurance department. This department monitors and reviews the CSRs' performance and coaches the CSRs as necessary.

The Company continually upgrades and enhances its management information systems. The Company believes it has the capacity to handle up to 30,000 calls per day.

The laws in most states require that contact lenses be sold pursuant to a valid prescription. In some states, the Company operates according to agreements it has entered into with local regulatory authorities or medical boards or agencies. The Company's current general operating practice is to obtain a copy of the customer's prescription or to passively verify each customer's prescription with his/her eye care practitioner. If the customer does not have a copy of his/her prescription, the Company asks the customer for his/her exact prescription specifications and then directly contacts the customer's eye care practitioner to passively verify the customer's prescription. The Company directly communicates to the eye care practitioner the prescription specifications received from the customer and informs the eye care practitioner that it will proceed to complete the sale based on such information unless the eye care practitioner advises it that such information is expired or incorrect. If the eye care practitioner does not advise the Company that such information is expired or incorrect within a minimum period, the Company's general practice is to complete the sale and ship the lenses based on the information communicated to the eye care practitioner. If the Company is unable to obtain a copy of the customer's prescription or passively verify the prescription with the customer's eye care practitioner, the Company's policy is not to proceed with the sale. The Company retains copies of the written prescriptions that it receives and maintains records of its communications with the customer's prescriber.

The Company has modified its operating systems to give eye care practitioners a minimum of eight business hours to respond to its prescription verification requests for Vistakon products. Eye care practitioners have the option of receiving these requests by fax. If the eye care practitioner notifies the Company within this time period that the customer's prescription is expired or otherwise invalid, the Company will not ship the order. Absent such notification from the eye care practitioner, the Company will proceed with the sale based on the prescription that was communicated to the eye care practitioner. This system applies to Vistakon orders nationwide with the exception of a few states where the Company has pre-existing agreements to employ more stringent procedures.

Internet. The Company's website, www.contacts.com, provides customers with a quick, efficient and cost-effective method for obtaining replacement contact lenses 24 hours a day, 7 days a week. The Company is continually upgrading the content and functionality of its website. The website allows customers to easily browse and purchase substantially all of the Company's products, promotes brand loyalty and encourages repeat purchases by providing an inviting customer experience. The Company has designed its website to be fast, secure and easy to use and to enable its customers to purchase products with minimal effort. The Company also offers Internet customers services such as free

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shipping, shipping confirmation and online order tracking. During the call center's operating periods, the Company offers service and support to its Internet customers over the telephone. The Company also provides e-mail support to customers 24 hours a day, 7 days a week. The Company's website allows customers to dispense with providing personal profile information after their initial order. The website has permitted the Company to expand its customer base through better service while reducing transaction costs.

The Company's online service automates the processing of customer orders, interacts with the management information systems and allows the Company to gather, store and use customer and transaction information in a

comprehensive and cost-efficient manner. The Company's website contains customized software applications that interface with the Company's management information systems.

The Company maintains a database containing information compiled from customer profiles, shopping patterns and sales data. The Company analyzes information in this database to develop targeted marketing programs and provide personalized and enhanced customer service. This database is scalable to permit large transaction volumes. The Company's systems support automated e-mail communications with customers to facilitate confirmations of orders, provide customer support, obtain customer feedback and engage in targeted marketing programs.

The Company uses a combination of proprietary and industry-standard encryption and authentication measures designed to protect a customer's information. The Company maintains an Internet firewall to protect its internal systems and all credit card and other customer information.

Distribution and Fulfillment. Approximately 94% of the Company's orders are shipped within one business day of receipt. Customers generally receive orders within one to five business days after shipping, depending upon the method of delivery chosen by the customer. A shipping and handling fee is charged on each customer order, except those orders received via the Internet and those received by mail with an enclosed check. Customers have the option of having their order delivered by overnight courier for an additional charge. The Company's management information systems automatically determine the anticipated delivery date for each order.

The Company uses an integrated packing and shipping system via a direct connection to the Company's management information systems. This system monitors the in-stock status of each item ordered, processes the order and generates warehouse selection tickets and packing slips for order fulfillment operations. The Company's management information systems are specifically designed with a number of quality control features to help ensure the accuracy of each order.

The Company's distribution center is strategically located near the Salt Lake City, Utah airport. In March 2002, the Company increased the size of its distribution center to approximately 84,000 square feet.

Manufacturing

All of ClearLab's products are manufactured in one production facility located in Singapore. See Properties. The facility currently has the capacity to produce in excess of 40 million lenses annually and is operating at approximately 30 to 35 percent of capacity. ClearLab manufactures its soft contact lenses by way of injection cast molding of plastic molds in which it doses various polymers. This process yields dry lenses which are then hydrated to their final wet state in order to become a complete lens. ClearLab also has the ability to wet cast mold lenses. In wet cast molding, the lenses are formed fully hydrated.

Purchasing and Principal Suppliers

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Until recently, substantially all of the major manufacturers of contact lenses refused to sell lenses to direct marketers, including the Company, and sought to prohibit their distributors from doing so. However, due to recent agreements entered into by the Company, Ocular Sciences is the only remaining major manufacturer who refuses to sell directly to the Company. Historically, the Company has purchased a substantial portion of its products from unauthorized distributors, but this is expected to decrease in the future.

In June 1994, the Attorney General for the State of Florida, acting on behalf of disposable contact lens consumers in that state, filed an anti-trust action against Johnson & Johnson, CIBA Vision, Bausch & Lomb and certain eye care practitioners and their trade associations alleging, among other things, that the contact lens manufacturers' policy not to sell to mail order distributors and others was adopted in conspiracy with eye care practitioners, as the result of pressure by eye care practitioners, in order to eliminate alternative channels of trade from the disposable lens market (the Florida Action).

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In December 1996, the Attorney General for the State of New York, on behalf of itself and the Attorney Generals for approximately 21 other States, filed a substantially similar action naming three major manufacturers of soft contact lenses as well as several optometrists and their trade associations as defendants (the New York Action). Additional states joined the New York Action after it was filed, and the Florida Action and the New York Action were consolidated (the Attorney General Action). The Attorney General Action, also referred to as the multi-district litigation, entered into the trial phase in March 2001 in Jacksonville, Florida.

CIBA Vision and Bausch & Lomb have entered into settlement agreements. In July 1997, the Company was approved as an authorized distributor of CIBA Vision. In March 2001, the Company was approved as an authorized distributor of Bausch & Lomb. Being an authorized distributor of these manufacturers allows the Company to purchase their contact lenses at wholesale level prices.

On May 22, 2001, the Middle District Court in Jacksonville, Florida announced a preliminary settlement with Johnson & Johnson. The court finalized the settlement agreement on November 1, 2001. The agreement became effective on December 1, 2001. In October 2001, the Company was granted intervener status to this multi-district litigation by the court. This status allowed the Company to become a party to the lawsuit for the limited purpose of enforcing the injunctive relief provisions of the settlement agreement, i.e., requiring Johnson & Johnson's eye care division, Vistakon, to sell its products directly to the Company. In December 2002, the Company announced that it had reached an agreement with Vistakon to become an authorized retailer of Vistakon contact lenses. The Company began buying directly from Vistakon during March 2003.

As a result of some manufacturers' refusal to sell to the Company, the Company is not an authorized dealer for some of the products which it sells. In addition, the Company believes that the price which it pays for certain products is sometimes higher than those paid by eye care practitioners, retail chains and mass merchandisers, who are able to buy directly from the manufacturers of such lenses and who benefit from being allowed to participate in cooperative advertising funds, coupon, sample, rebate and other marketing and promotional programs. Although the Company has been able to obtain most contact lens brands at competitive prices in sufficient quantities on a regular basis, there can be no assurance that the Company will not encounter difficulties in the future. The inability of the Company to obtain sufficient quantities of contact lenses at competitive prices would have a material adverse effect on the Company's business, financial condition and results of operations.

Although the Company seeks to reduce its reliance on any one supplier by establishing relationships with a number of distributors, manufacturers and other sources, the Company acquired from a single distributor approximately 35 percent, 46 percent and 35 percent of its contact lens purchases in fiscal 2000, 2001 and 2002, respectively. The Company's top three suppliers accounted for approximately 62 percent, 70 percent and 63 percent of the Company's inventory purchases in fiscal 2000, 2001 and 2002, respectively. The Company continually seeks to establish new relationships with potential suppliers in order to obtain adequate inventory at competitive prices. In the event that these suppliers could no longer supply the Company with contact lenses, there can be no assurance that the Company could secure other adequate sources of supply, or that such supply could be obtained on terms no less favorable to the Company than its current supply, which could adversely affect the Company by increasing its costs or, in the event adequate replacement supply cannot be secured, reducing its net sales. In that regard, the Company does not have any contracts with manufacturers or distributors of contact lenses which provide for an absolute guarantee of supply to the Company.

ClearLab is in the process of designing and developing a new brand of disposable contact lens that will provide the Company increased control of production and inventory and the flexibility to make a variety of offers to its customers to enhance its capability to provide high quality, cost-effective products. The Company expects to begin marketing lenses made by ClearLab to its customers in the second quarter of fiscal 2003.

Competition

The retail sale of contact lenses is a highly competitive and fragmented industry. Traditionally, contact lenses were sold to customers almost exclusively by eye care practitioners in connection with providing them an eye examination. Competition for patients and the revenue related to providing them contact lenses significantly increased as

optical chains and large discount retailers began providing optical services and has further intensified with the entry of direct marketers such as the Company. The Company believes that the eye care profession suffers from a surplus of eye care practitioners, and that the resulting competitive pressure has been exacerbated by the increased prevalence of retail optical chains, mass merchandisers and direct marketers. Consequently, the competition amongst eye care practitioners to acquire customers and the competition to provide replacement lenses to such customers has intensified.

The Company's principal competitors include ophthalmologists and optometrists in private practice. The Company also competes with national optical chains, such as Cole Vision, LensCrafters and National Vision Association and mass merchandisers, such as Wal-Mart, Sam's and Costco. In addition, the Company competes with other direct marketers of contact lenses. The Company may face increased competition in the future from new entrants in the direct marketing business, which may include national optical chains and mass merchandisers, some of which may have significantly greater resources than the Company.

The Company believes that many of its competitors, including most eye care practitioners, national optical chains and mass merchandisers, have direct supply arrangements with contact lens manufacturers, which in some cases affords such competitors with better pricing terms, access to supply and other sales and marketing programs. In addition, some of the competitors are significantly larger in overall revenues and have significantly greater resources than the Company. The Company believes that the principal elements of competition in the industry include price, product availability, customer service and consumer awareness.

Government Regulation

Direct Marketing

Federal Regulation

Contact lenses are regulated by the Food and Drug Administration (FDA) as medical devices. The FDA classifies medical devices as Class I, Class II or Class III and regulates them to varying degrees, with Class I medical devices subject to the least amount of regulation and Class III medical devices subject to the most stringent regulations. Rigid gas permeable and soft contact lenses are classified as Class II medical devices if intended only for daily wear and as Class III medical devices if intended for extended wear. These regulations generally apply only to the manufacturing of contact lenses, and therefore do not directly impact the direct marketing operations of the Company. Federal regulations also require the labels on medical devices to contain adequate instructions for their safe and proper use. However, there is an exemption from this requirement for medical devices the use of which is not safe except under the supervision of a practitioner licensed by law to direct the use of such device. Devices which fall in this exception must contain as part of their labeling the statement "Caution: Federal law restricts this device to sale by or on the order of _____ (physician or other licensed practitioner), the blank to be filled in with the word physician or other practitioner authorized by the law of the state in which the practitioner practices to use or order the use of the device. The FDA considers contact lenses to qualify for this labeling exemption; however, a device bearing this legend that is dispensed without a prescription may be considered misbranded by the FDA. Potential penalties for misbranding include warning letters from the FDA, seizure, injunction, civil penalties, or prosecution. To date, the FDA has not taken any such action against the Company.

State Regulati