

GOLFSMITH INTERNATIONAL HOLDINGS INC

Form 10-Q

August 16, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 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 July 2, 2005**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number 333-101117**

**GOLFSMITH INTERNATIONAL HOLDINGS, INC.**

**(Exact Name of Registrant as Specified in Its Charter)**

Delaware  
(State or Other Jurisdiction of Incorporation or  
Organization)

16-1634897  
(I.R.S. Employer Identification No.)

11000 N. IH-35, Austin, Texas  
(Address of Principal Executive Offices)

78753  
(zip code)

Registrant's Telephone Number, Including Area Code: (512) 837-8810

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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

Class of Common Stock

Outstanding at August 16, 2005

\$.001 par value

21,594,597 Shares

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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.  
QUARTERLY REPORT  
FOR THE QUARTER ENDED JULY 2, 2005**

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Consolidated Balance Sheets**

	<b>July 2, 2005 (Unaudited)</b>	<b>January 1, 2005</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 5,774,190	\$ 14,786,748
Receivables, net of allowances of \$184,657 at July 2, 2005 and \$161,838 at January 1, 2005	2,128,519	854,555
Inventories, net of reserves of \$2,305,049 at July 2, 2005 and \$1,385,650 at January 1, 2005	80,678,386	54,197,532
Prepaid and other current assets	7,521,379	6,405,525
Total current assets	96,102,474	76,244,360
Property and equipment:		
Land and buildings	21,160,229	21,133,430
Equipment, furniture, fixtures and autos	17,903,021	15,174,320
Leasehold improvements and construction in progress	18,241,007	15,247,612
	57,304,257	51,555,362
Less: accumulated depreciation	(12,743,641)	(10,647,641)
Net property and equipment	44,560,616	40,907,721
Goodwill	41,634,525	41,634,525
Tradename	11,158,000	11,158,000
Trademarks	14,483,175	14,483,175
Customer database, net of accumulated amortization of \$1,038,646 at July 2, 2005 and \$849,801 at January 1, 2005	2,360,559	2,549,404
Debt issuance costs, net of accumulated amortization of \$2,582,345 at July 2, 2005 and \$2,062,104 at January 1, 2005	5,275,370	5,795,611
Other long-term assets	490,273	368,285
Total assets	\$216,064,992	\$193,141,081

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**Golfsmith International Holdings, Inc.**  
**Consolidated Balance Sheets (continued)**

	<b>July 2, 2005</b>	<b>January 1, 2005</b>
	<b>(Unaudited)</b>	
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 56,090,587	\$ 37,218,275
Accrued expenses and other current liabilities	16,352,255	18,717,115
Line of credit	669,792	
<b>Total current liabilities</b>	<b>73,112,634</b>	<b>55,935,390</b>
Long-term debt	81,087,926	79,808,033
Deferred rent	3,653,765	3,084,367
<b>Total liabilities</b>	<b>157,854,325</b>	<b>138,827,790</b>
Stockholders equity:		
Common stock \$.001 par value; 40,000,000 shares authorized; 21,594,597 shares issued and outstanding at July 2, 2005 and January 1, 2005, respectively	21,594	21,594
Restricted common stock units \$.001 par value; 755,935 shares issued and outstanding at July 2, 2005 and January 1, 2005, respectively	756	756
Additional capital	60,288,607	60,288,607
Other comprehensive income	174,908	279,607
Accumulated deficit	(2,275,198)	(6,277,273)
<b>Total stockholders equity</b>	<b>58,210,667</b>	<b>54,313,291</b>
<b>Total liabilities and stockholders equity</b>	<b>\$216,064,992</b>	<b>\$193,141,081</b>

*See accompanying notes.*

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**Golfsmith International Holdings, Inc.**  
**Consolidated Statements of Operations**  
**(Unaudited)**

	Six Months Ended		Three Months Ended	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net revenues	\$ 166,451,893	\$ 162,725,773	\$ 102,493,511	\$ 96,943,734
Cost of products sold	105,856,380	106,376,412	64,660,890	63,569,555
Gross profit	60,595,513	56,349,361	37,832,621	33,374,179
Selling, general and administrative	49,364,259	47,071,670	27,964,324	26,903,777
Store pre-opening expenses	1,403,519	382,198	886,762	52,960
Total operating expenses	50,767,778	47,453,868	28,851,086	26,956,737
Operating income	9,827,735	8,895,493	8,981,535	6,417,442
Interest expense	(5,750,630)	(5,596,567)	(2,888,528)	(2,801,162)
Interest income	62,960	4,525	45,520	3,794
Other income	31,090	27,749	8,492	25,315
Other expense	(71,978)	(46,173)	(48,230)	(33,006)
Income before income taxes	4,099,177	3,285,027	6,098,789	3,612,383
Income tax expense	(97,102)	(1,222,794)	(97,102)	(1,347,189)
Net income	\$ 4,002,075	\$ 2,062,233	\$ 6,001,687	\$ 2,265,194

*See accompanying notes.*

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**Golfsmith International Holdings, Inc.**  
**Consolidated Statements of Cash Flows**  
**(Unaudited)**

	Six Months Ended	
	July 2, 2005	July 3, 2004
<b>Operating Activities</b>		
Net income	\$ 4,002,075	\$ 2,062,233
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	2,695,594	2,702,893
Amortization of intangible assets	188,845	188,845
Amortization of debt issue costs and debt discount	1,800,134	1,601,520
Non-cash loss on write-off of property and equipment	573,384	387,902
(Gain) loss on sale of assets	(11,500)	2,257
Changes in operating assets and liabilities:		
Accounts receivable	(1,273,964)	(1,955,627)
Inventories	(26,480,854)	(9,257,135)
Prepaid and other assets	(1,237,842)	(1,838,342)
Accounts payable	18,872,312	14,319,896
Accrued expenses and other current liabilities	(2,362,616)	(486,192)
Deferred rent	569,398	134,321
Net cash provided by (used in) operating activities	(2,665,034)	7,862,571
<b>Investing Activities</b>		
Capital expenditures	(6,924,915)	(3,959,422)
Proceeds from sale of assets	11,500	5,000
Net cash used in investing activities	(6,913,415)	(3,954,422)
<b>Financing Activities</b>		
Principal payments on lines of credit	(3,285,699)	(33,457,298)
Proceeds from lines of credit	3,955,491	32,040,259
Other	(2,244)	(3,235)
Net cash provided by (used in) financing activities	667,548	(1,420,274)
Effect of exchange rate changes on cash	(101,657)	40,358
Change in cash and cash equivalents	(9,012,558)	2,528,233
Cash and cash equivalents, beginning of period	14,786,748	2,928,109
Cash and cash equivalents, end of period	\$ 5,774,190	\$ 5,456,342

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**Golfsmith International Holdings, Inc.**  
**Consolidated Statements of Cash Flows (continued)**  
**(Unaudited)**

	<b>Six Months Ended</b>	
	<b>July 2, 2005</b>	<b>July 3, 2004</b>
Supplemental cash flow information:		
Interest payments	<b>\$3,959,165</b>	<b>\$4,015,978</b>
Tax payments	<b>\$ 206,513</b>	<b>\$ 163,898</b>
<i>See accompanying notes.</i>		



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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

**July 2, 2005**

**1. Nature of Business and Basis of Presentation**

*Description of Business*

Golfsmith International Holdings, Inc. ( Holdings or the Company ), is a multi-channel, specialty retailer of golf and tennis equipment and related apparel and accessories and a designer and marketer of golf equipment. The Company offers golf equipment from leading manufacturers, including Callaway®, Cobra®, FootJoy®, Nike®, Ping®, Taylor Made® and Titleist®. In addition, the Company offers its own proprietary brands, including Golfsmith®, Lynx®, Snake Eyes®, Killer Bee®, Zevo®, GearForGolf™ and GiftsForGolf™. As of July 2, 2005, the company marketed its products through 49 superstores as well as through its direct-to-consumer channels, which include its clubmaking and consumer catalogs and its Internet site. The Company also operates the Harvey Penick Golf Academy, an instructional school incorporating the techniques of the well-known golf instructor, the late Harvey Penick.

*Basis of Presentation*

The accompanying consolidated financial statements include the accounts of Golfsmith International Holdings, Inc. and its wholly owned subsidiary Golfsmith International, Inc. ( Golfsmith ). Holdings has no operations nor does it have any assets or liabilities other than its investment in its wholly owned subsidiary. Accordingly, these consolidated financial statements represent the operations of Golfsmith and its subsidiaries. All significant inter-company accounts and transactions have been eliminated in consolidation.

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles. As information in this report relates to interim financial information, certain footnote disclosures have been condensed or omitted. In the Company's opinion, the unaudited interim consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) necessary for a fair presentation of the Company's financial position, results of operations and cash flows for the periods presented. These consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements and notes thereto for the year ended January 1, 2005, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2005. The results of operations for the three and six month periods ended July 2, 2005 are not necessarily indicative of results that may be expected for any other interim period or for the full fiscal year.

The balance sheet at January 1, 2005 has been derived from audited consolidated financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. For further information, refer to the audited consolidated financial statements and notes thereto for the fiscal year ended January 1, 2005 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission on April 1, 2005.

*Revenue Subject to Seasonal Variations*

The Company's business is seasonal. The Company's sales leading up to and during the warm weather golf season and the Christmas holiday gift-giving season have historically contributed a higher percentage of the Company's annual net revenues and annual net operating income than other periods in its fiscal year.

*Fiscal Year*

The Company's fiscal year ends on the Saturday closest to December 31. The three months ended July 2, 2005 and July 3, 2004 both consist of thirteen weeks. The six months ended July 2, 2005 and July 3, 2004 both consist of twenty-six weeks.

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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**  
**July 2, 2005**

**2. Stock-Based Compensation**

The Company accounts for its stock-based compensation plans under Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. The following table illustrates the effect on net income, if the Company had applied the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosure, An Amendment of FASB Statement No. 123*:

	<b>Six Months Ended</b>		<b>Three Months Ended</b>	
	<b>July 2, 2005</b>	<b>July 3, 2004</b>	<b>July 2, 2005</b>	<b>July 3, 2004</b>
Net income as reported	<b>\$4,002,075</b>	<b>\$2,062,233</b>	<b>\$6,001,687</b>	<b>\$2,265,194</b>
Total stock-based compensation cost, net of related tax effects included in the determination of net income as reported				
The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards	<b>(116,541)</b>	<b>(87,415)</b>	<b>(56,370)</b>	<b>(42,832)</b>
Pro forma net income	<b>\$3,885,534</b>	<b>\$1,974,818</b>	<b>\$5,945,317</b>	<b>\$2,222,362</b>

**3. Long-Lived Assets**

The Company accounts for the impairment or disposal of long-lived assets in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment of Long-Lived Assets*, which requires long-lived assets, such as property and equipment, to be evaluated for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when estimated future undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset, if any, are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value in the period in which the determination is made. Included in selling, general and administrative expenses for the three and six months ended July 2, 2005 is a \$0.6 million non-cash loss on the write-off of property and equipment. The loss was primarily due to the remodeling of five stores and the modification of one store to a smaller store layout, which resulted in certain assets having little or no future economic value. Included in selling, general and administrative expenses for the three and six months ended July 3, 2004 is a \$0.4 million non-cash loss on the write-off of property and equipment. The loss was primarily due to an anticipated retail store relocation, which resulted in certain assets having little or no future economic value.

**4. Intangible Assets**

The following is a summary of the Company's intangible assets that are subject to amortization:

	<b>July 2, 2005</b>	<b>January 1, 2005</b>
Customer database gross carrying amount	\$ 3,399,205	\$3,399,205
Customer database accumulated amortization	(1,038,646)	(849,801)
Customer database net carrying amount	\$ 2,360,559	\$2,549,404

Amortization expense related to finite-lived intangible assets was \$94,422 and \$188,845 for each of the three and six months ended July 2, 2005 and July 3, 2004, respectively, and is recorded in selling, general, and administration expenses on the consolidated statements of operations.

**5. Debt**

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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**July 2, 2005**

*Senior Secured Notes*

On October 15, 2002, Golfsmith completed an offering of \$93.75 million aggregate principal amount at maturity of 8.375% senior secured notes due in 2009 at a discount of 20%, or \$18.75 million. The terms of the notes limit the ability of Golfsmith to, among other things, incur additional indebtedness, dispose of assets, make acquisitions, make other investments, pay dividends and make various other payments. The terms of the notes also contain certain other covenants, including a restriction on capital expenditures. In March 2005, the indenture governing the notes was amended to revise the definition of capital expenditure basket to increase by \$5.0 million the limitation on capital expenditures that may be made by Golfsmith or the guarantors of the notes during any given fiscal year. As of July 2, 2005, the Company believes it was in compliance with the covenants imposed by the indenture governing the notes.

*Credit Facility*

Golfsmith has a revolving senior credit facility with \$12.5 million availability, subject to a required reserve of \$500,000. Borrowings under the credit facility are secured by substantially all of Golfsmith's assets, excluding real property, equipment and proceeds thereof owned by Golfsmith, Holdings, or Golfsmith's subsidiaries, and all of Golfsmith's stock and equivalent equity interest in any subsidiaries. Available amounts under the senior credit facility are based on a borrowing base. The borrowing base is limited to 85% of the net amount of eligible receivables, as defined in the credit agreement, plus the lesser of (i) 65% of the value of eligible inventory and (ii) 60% of the net orderly liquidation value of eligible inventory, and minus \$2.5 million, which is an availability block used to calculate the borrowing base. At July 2, 2005, the Company had \$0.7 million outstanding under the senior credit facility.

In March 2005, several financial covenants in the senior credit facility were amended. The limit on capital expenditures in each fiscal year was increased to the greater of (a) one-third of Holdings' EBITDA (as defined in the senior credit facility) in the immediately preceding fiscal year and (b) the sum of: (i) \$12.0 million, (ii) the amount, if any, of the excess cash flow (as defined in the indenture to the senior secured notes) offer made and not accepted by the holders of the senior secured notes during the immediately preceding fiscal year, and (iii) any amounts, up to an aggregate of \$1,000,000, previously permitted to be made as capital expenditures that have not previously been made as capital expenditures. In addition, the covenants regarding minimum interest coverage ratios and minimum earnings levels were removed for the fiscal period ending on or about September 30, 2004 and all fiscal periods thereafter. Finally, the definition of borrowing base in the senior credit facility was amended to include an availability block of \$2.5 million, as used to calculate the borrowing base under the senior credit facility. As of July 2, 2005, the Company believes it was in compliance with the covenants in the credit facility.

**6. Guarantees**

Holdings and all of Golfsmith's existing domestic subsidiaries fully and unconditionally guarantee, and all of Golfsmith's future domestic subsidiaries will guarantee, both the senior secured notes issued by Golfsmith in October 2002 and the senior credit facility. The senior secured notes mature in October 2009 with certain mandatory redemption features. Interest payments are required on a semi-annual basis on the senior secured notes at an annual interest rate of 8.375%. At July 2, 2005, there were \$0.7 million in borrowings outstanding under the senior credit facility and \$81.1 million aggregate principal amount outstanding of the senior secured notes.

Holdings has no operations nor any assets or liabilities other than its investment in its wholly owned subsidiary Golfsmith. Golfsmith has no independent operations nor any assets or liabilities other than its investments in its wholly owned subsidiaries. Domestic subsidiaries of Golfsmith comprise all of Golfsmith's assets, liabilities and operations. There are no restrictions on the transfer of funds between Holdings, Golfsmith and any of Golfsmith's domestic subsidiaries. The guarantees of Holdings and all existing and future Golfsmith domestic subsidiaries of Golfsmith's senior secured notes and senior credit facility are explicitly excluded from the initial recognition and initial measurement requirements of FASB Interpretation No. 45 as it meets the definition of an intercompany guarantee.

The Company offers warranties to its customers depending on the specific product and terms of the goods purchased. A typical warranty program requires that the Company replace defective products within a specified time

period from the date of sale. The Company records warranty costs as they are incurred and historically such costs have not been material. During the three and six months ended July 2, 2005 and July 3, 2004, respectively, no material amounts have been accrued or paid relating to product warranties.

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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(UNAUDITED)**

**July 2, 2005**

**7. Accrued Expenses and Other Current Liabilities**

The Company's accrued expenses and other current liabilities are comprised of the following at July 2, 2005 and January 1, 2005, respectively:

	<b>July 2, 2005</b>	<b>January 1, 2005</b>
Salaries and benefits	\$ 1,371,823	\$ 1,791,931
Interest	2,638,729	2,647,670
Allowance for returns reserve	1,552,512	1,326,394
Gift certificates	5,961,424	7,521,148
Taxes	2,709,873	3,169,661
Other	2,117,894	2,260,311
<b>Total</b>	<b>\$16,352,255</b>	<b>\$18,717,115</b>

**8. Comprehensive Income**

The Company's comprehensive income is composed of net income and translation adjustments. The following table presents the calculation of comprehensive income:

	<b>Six Months Ended</b>		<b>Three Months Ended</b>	
	July 2, 2005	July 3, 2004	July 2, 2005	July 3, 2004
Net income	\$4,002,075	\$2,062,233	\$6,001,687	\$2,265,194
Translation adjustments	(104,699)	40,358	(76,177)	2,518
<b>Total comprehensive income</b>	<b>\$3,897,376</b>	<b>\$2,102,591</b>	<b>\$5,925,510</b>	<b>\$2,267,712</b>

**9. Recently Issued Accounting Standards**

During fiscal year 2004, the Company adopted EITF 03-10, *Application of Issue 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers*, which amends EITF 02-16. According to the amended guidance, if certain criteria are met, consideration received by a reseller in the form of reimbursement from a vendor for honoring the vendor's sales incentives offered directly to consumers (for example, manufacturers' coupons) should not be recorded as a reduction of the cost of the reseller's purchases from the vendor. The adoption of EITF 03-10 did not impact the Company's financial condition, results of operations or cash flows.

In December 2004, the Financial Accounting Standards Board, or FASB, issued SFAS No. 123 (Revised), *Share-Based Payment* (SFAS No. 123 (R)), which replaces SFAS No. 123 and supercedes Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB No. 25. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. SFAS 123(R) is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. SFAS 123(R) applies to all awards granted after the required effective date, but does not apply to awards granted in periods before the required effective date because the Company uses the minimum value method, except if prior awards are modified, repurchased or cancelled after the effective date. The Company will adopt SFAS No. 123(R) on January 1, 2006. The impact of the adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, valuation of employee stock options under SFAS 123(R) is similar to SFAS 123, with minor

exceptions. For information about what the Company's reported results of operations would have been had the Company adopted SFAS 123, see Note 2, Stock-Based Compensation .

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**GOLFSMITH INTERNATIONAL HOLDINGS, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)**

**July 2, 2005**

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29* (SFAS 153). The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to that principle. SFAS 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 is not expected to have a material impact on the Company's financial condition, results of operations or cash flows.

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

We are the parent company of Golfsmith International, Inc., or Golfsmith. We have no operations nor any assets or liabilities other than our investment in our wholly owned subsidiary Golfsmith. The following discussion and analysis of historical financial condition and results of operations is based on our financial condition and results of operations for all periods presented.

We are a multi-channel, specialty retailer of golf and tennis equipment and related apparel and accessories and a designer and marketer of golf equipment. We sell brand name golf equipment from the industry's leading manufacturers including Callaway®, Cobra®, FootJoy®, Ping®, Nike®, Taylor Made® and Titleist® as well as our own proprietary brands, Golfsmith®, Lynx®, Snake Eyes®, Killer Bee®, Zevo®, GearForGolf™ and GiftsForGolf™. We sell through multiple distribution channels consisting of:

51 superstores;

regular mailings of our clubmakers' catalogs, which offer golf club components, and our consumer catalogs, which offer golf accessories, apparel and equipment; and

golfsmith.com, our online e-commerce website.

We also operate a clubmaker training program and are the exclusive operator of the Harvey Penick Golf Academy, an instructional school incorporating the techniques of the well-known golf instructor, the late Harvey Penick.

#### *Industry Trends*

Sales of our products are affected by increases and declines within the golf industry as a whole. According to national publications, the golf industry is a greater than \$62 billion industry. We believe that increases and declines in the golf industry result from changes in the overall economy, the number of golf participants, the number of rounds of golf being played by these participants and the weather. According to a recent industry publication, golf had a base of over 27 million participants in the United States as of the end of calendar year 2004. We believe that since 1998, the overall worldwide premium golf club market has experienced only limited growth in dollar volume from year to year and that from 1999 to 2004 there was no material increase in the number of rounds played. Golf Datatech has reported that the number of golf rounds played in the United States declined 0.1% in 2004 as compared to 2003. In addition, Golf Datatech has reported that the number of golf rounds played in the United States declined 1.3% during the six months ended June 30, 2005 as compared to the same period in 2004. However, the rate of decline during the six months ended June 30, 2005 was driven largely by comparable decline during the first quarter of calendar year 2005. Golf Datatech has reported that the rate of growth in the number of rounds played decreased 7.6% in the three months ended March 31, 2005 and then increased 1.0% in the three months ended June 30, 2005, in each case compared to the corresponding period in 2004. We cannot assure you that a decline in the U.S. economy or a reduction in discretionary consumer spending would not impede growth in the worldwide market for golf-related products, including our products.

#### *Superstores*

Our superstores range in size from 8,000 to 33,000 square feet and average approximately 18,000 square feet. Our superstores feature a wide selection of golf and tennis equipment, apparel and accessories from major brand manufacturers and also serve as the primary outlet in the United States for our proprietary branded products. Our superstores accounted for approximately 72.6% and 70.5% of our net revenues for the three and six months ended July 2, 2005, respectively, and 70.0% and 67.4% of our net revenues for the three and six months ended July 3, 2004. Changes in the revenues that we generate from our superstores are driven primarily by the number of stores in operation and changes in comparable store sales. We had 49 and 42 superstores in operation as of July 2, 2005 and July 3, 2004, respectively. We consider sales of a new store to be comparable commencing in the fourteenth month after the store was opened or acquired. We consider sales of a relocated store to be comparable if the relocated store is expected to serve a comparable customer base. We consider sales of superstores with modified layouts to be comparable. We consider sales of stores that are closed to be comparable in the period leading up to closure if they have met the qualifications of a comparable store and do not meet the qualifications to be classified as discontinued

operations under Statement of Financial Accounting Standards (SFAS) No. 144, *Accounting for the Impairment of Long-Lived Assets*.

We intend to selectively expand our existing store base in existing as well as new markets that fit our selection criteria. We opened four superstores during the six months ended July 2, 2005, and we plan to open four superstores during the remaining two quarters of fiscal 2005, one of which opened in July 2005 and one of which opened in August 2005. We plan for all of the new

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stores built during fiscal 2005 to be in the mold of our smaller store layout, which generally range in size from 12,000 to 15,000 square feet. We closed one store during the six months ended July 2, 2005 due to the expiration of the lease term. The new store that we opened during August 2005 is a non-comparable store that serves the same customer base of the closed store. We expect to spend approximately \$1.5 million to open each additional superstore, which includes pre-opening expenses, capital expenditures and inventory costs.

We plan to modify select superstores to feature our fitting and training specialty services that provide the customer with an experiential shopping experience that complements our product assortment. As of July 2, 2005, seven of our superstores provided precision golf equipment fitting through an arrangement with Hot Stix Technologies, or Hotstix. During the remaining two quarters of fiscal 2005, we plan to add or modify indoor hitting ranges in 12 existing superstores as well as all planned new superstores to feature this precision golf equipment-fitting technology. In addition, as of July 2, 2005, 22 of our superstores provided in-store golf lessons from a PGA professional through our relationship with GolfTEC Learning Centers, or GolfTEC. During the remaining two quarters of fiscal 2005, we plan to modify two of our existing superstores to accommodate in-store golf lessons through GolfTEC. We also plan to provide in-store golf lessons through GolfTEC in the four new superstores which we plan to open in the remaining two quarters of fiscal 2005, including the stores opened in July 2005 and August 2005.

We also plan to modify select superstores to feature expanded hitting bays, putting greens and short game areas that provide the customer with an experiential shopping experience that complements our product assortment. We updated three superstores to provide this enhanced customer shopping experience during the six months ended July 2, 2005. We further plan to continue to update and remodel existing superstores to provide a more consistent shopping experience among our superstores. In addition, during the six months ended July 2, 2005, we updated 21 of our existing and new stores to feature tennis equipment, apparel and accessories, which as of July 2, 2005, were featured in 27 of our 49 stores. We modified one superstore to our smaller store layout during the six months ended July 2, 2005. We do not plan to modify any more of our superstores to the smaller store layout.

*Specialty Services*

Over the past few years we have implemented a number of new initiatives and product offerings such as our Playability Guarantee program designed to ensure complete customer satisfaction with our customers purchase of golf clubs; our Club Vantage program that provides the customer with separately-priced repair service on any club purchase; the Golfsmith credit card which offers flexible payment options on any purchase; as described above, the availability of in-store custom golf equipment fitting through Hot Stix, which complements our existing custom fitting services and the availability of in-store golf lessons from a PGA professional through GolfTEC. We believe our continued market expansion combined with these new initiatives have contributed to increased market presence and brand recognition, as evidenced by the increase in our net revenues during the six months ended July 2, 2005 compared to the six months ended July 3, 2004. You should read the discussion of our revenue growth below in Results of Operations.

*Products*

The majority of our sales are comprised of golf equipment, apparel and accessories from leading manufacturers, including Callaway®, Cobra®, FootJoy®, Nike®, Ping®, Taylor Made® and Titleist®. We also sell proprietary brand equipment, component, apparel and accessory products under the Golfsmith®, Lynx®, Snake Eyes®, Killer Bee®, Zevo®, GearForGolf™ and GiftsForGolf™ product lines. These private label lines are included in all of our sales distribution channels and generate higher gross profit margins than products we sell that are produced by other manufacturers. Sales of our proprietary brands constituted approximately 16.4% and 16.7% of our net revenues for the three and six months ended July 2, 2005, respectively, and approximately 18.6% and 18.9% of our net revenues for the three and six months ended July 3, 2004, respectively.

We recognize revenue for retail sales at the time the customer takes possession of the merchandise and purchases are paid for, primarily with either cash or a credit card. Catalog and e-commerce sales are recorded upon shipment of merchandise. Revenue from the Harvey Penick Golf Academy instructional school is recognized at the time the services are performed. Revenues from the sale of gift certificates are recorded upon the redemption of the gift certificate for the purchase of tangible products at the time the customer takes possession of the merchandise.

Our business is seasonal. Our sales leading up to and during the warm weather golf season and the Christmas holiday gift-giving season have historically contributed a higher percentage of our annual net revenues and annual net operating income than other periods in our fiscal year. During fiscal 2004, the fiscal months of March through September and December, which together comprised 36 weeks of our 52-week fiscal year, contributed over three-quarters of our annual net revenues and substantially all of our annual operating income. You should read the information set forth below under **Additional Factors That May Affect Future Results** for a discussion of the effects and risks of the seasonality of our business.

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We capitalize inbound freight and vendor discounts into inventory upon receipt of inventory. These costs are then subsequently included in cost of goods sold upon the sale of that inventory. Because some retailers exclude these costs from cost of goods sold, and instead include them in a line item like selling and administrative expenses, our gross margins may not be comparable to those of these other retailers.

Our fiscal year ends on the Saturday closest to December 31 and generally consists of 52 weeks, though occasionally our fiscal years will consist of 53 weeks. Each quarter of each fiscal year generally consists of 13 weeks. The three-month periods ended July 2, 2005 and July 3, 2004 each consisted of 13 weeks and the six-month periods ended July 2, 2005 and July 3, 2004 each consisted of 26 weeks.

**Critical Accounting Policies and Estimates**

Management's discussion and analysis of financial condition and results of operations is based on our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities. The estimates and assumptions are evaluated on an ongoing basis and are based on historical experience and other various factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates.

We believe the following critical accounting policies, as have been discussed with our audit committee, affect our more significant judgments and estimates used in the preparation of our consolidated financial statements.

*Inventory Valuation*

Inventory value is presented as a current asset on our balance sheet and is a component of cost of products sold in our statement of operations. It therefore has a significant impact on the amount of net income reported in any period. Merchandise inventories are carried at the lower of cost or market. Cost is the sum of expenditures, both direct and indirect, incurred to bring inventory to its existing condition and location. Cost is determined using the weighted-average method. We estimate a reserve for damaged, obsolete, excess and slow-moving inventory and for inventory shrinkage due to anticipated book-to-physical adjustments. We periodically review these reserves by comparing them to on-hand quantities, historical and projected rates of sale, changes in selling price and inventory cycle counts. Based on our historical results, using various methods of disposition, we estimate the price at which we expect to sell this inventory to determine the potential loss if those items are later sold below cost. The carrying value for inventories that are not expected to be sold at or above costs are then written down. A significant adjustment in these estimates or in actual sales may have a material adverse impact on our net income. Shrink reserves are booked on a monthly basis at 0.4% to 1.0% of net revenues depending on the distribution channel (direct-to-consumer channel or retail channel) in which the sales occur. Inventory shrink expense recorded in the statements of operations was 0.80% of net revenues during the three and six months ended July 2, 2005, and 0.77% and 0.71% during the three and six months ended July 3, 2004, respectively. Inventory shrink expense recorded is a result of physical inventory counts made during these respective periods and reserve amounts recorded for periods outside of the physical inventory count dates. These reserve amounts are based on management's estimates of shrink expense using historical experience.

*Long-lived Assets, Including Goodwill and Identifiable Intangible Assets*

We account for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Assets*, which requires long-lived assets, such as property and equipment, to be evaluated for impairment whenever events or changes in circumstances indicate the carrying value of an asset may not be recoverable. An impairment loss is recognized when estimated future undiscounted cash flows expected to result from the use of the asset plus net proceeds expected from disposition of the asset, if any, are less than the carrying value of the asset. When an impairment loss is recognized, the carrying amount of the asset is reduced to its estimated fair value. Based on our analyses, included in selling, general and administrative expenses for the three and six months ended July 2, 2005 is a \$0.6 million non-cash loss on the write-off of property and equipment. The loss was primarily due to the remodeling of five stores and the modification of one store to a smaller store layout, which resulted in certain assets having little or no future economic value. In addition, included in selling, general and administrative expenses for the three and six months ended July 3, 2004 is a \$0.4 million non-cash loss on the write-off of property

and equipment. The loss was primarily due to an anticipated retail store relocation, which resulted in certain assets having little or no future economic value.

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Goodwill represents the excess purchase price over the fair value of net assets acquired, or net liabilities assumed, in a business combination. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets*, we assess the carrying value of our goodwill for indications of impairment annually, or more frequently if events or changes in circumstances indicate that the carrying amount of goodwill or intangible asset may be impaired. The goodwill impairment test is a two-step process. The first step of the impairment analysis compares the fair value of the company or reporting unit to the net book value of the company or reporting unit. We allocate goodwill to one enterprise-level reporting unit for impairment testing. In determining fair value, we utilize a blended approach and calculate fair value based on discounted cash flow analysis and revenue and earnings multiples based on industry comparables. Step two of the analysis compares the implied fair value of goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, an impairment loss is recognized equal to that excess. We perform our annual test for goodwill impairment on the first day of the fourth fiscal quarter of each year.

We test for possible impairment of intangible assets whenever events or changes in circumstances indicate that the carrying amount of the asset is not recoverable based on management's projections of estimated future discounted cash flows and other valuation methodologies. Factors that are considered by management in performing this assessment include, but are not limited to, our performance relative to our projected or historical results, our intended use of the assets and our strategy for our overall business, as well as industry and economic trends. In the event that the book value of intangibles is determined to be impaired, such impairments are measured using a combination of a discounted cash flow valuation, with a discount rate determined to be commensurate with the risk inherent in our current business model, and other valuation methodologies. To the extent these future projections or our strategies change, our estimates regarding impairment may differ from our current estimates.

*Product Return Reserves*

We reserve for product returns based on estimates of future sales returns related to our current period sales. We analyze historical returns, current economic trends, current returns policies and changes in customer acceptance of our products when evaluating the adequacy of the reserve for sales returns. Any significant increase in merchandise returns that exceeds our estimates could adversely affect our operating results. In addition, we may be subject to risks associated with defective products, including product liability. Our current and future products may contain defects, which could subject us to higher defective product returns, product liability claims and product recalls. Because our allowances are based on historical return rates, we cannot assure you that the introduction of new merchandise in our stores or catalogs, the opening of new stores, the introduction of new catalogs, increased sales over the Internet, changes in the merchandise mix or other factors will not cause actual returns to exceed return allowances. We book reserves on a monthly basis at 1.8% to 10.8% of net revenues depending on the distribution channel in which the sales occur. We routinely compare actual experience to current reserves and make any necessary adjustments.

*Store Closure Costs*

When we decide to close a store and meet the applicable accounting guidance criteria, we recognize an expense related to the future net lease obligation and other expenses directly related to the discontinuance of operations in accordance with SFAS No. 146, *Accounting For Costs Associated With Exit or Disposal Activities*. These charges require us to make judgments about exit costs to be incurred for employee severance, lease terminations, inventory to be disposed of, and other liabilities. The ability to obtain agreements with lessors, to terminate leases or to assign leases to third parties can materially affect the accuracy of these estimates.

We closed one store during the six months ended July 2, 2005 due to the expiration of the lease term. There were not any expenses associated with this closed store recorded in accordance with SFAS No. 146. We opened a new store in August 2005 in order to serve the same customer base of the closed store. We did not close any stores in fiscal 2004. We do not currently have any plans to close any additional stores, although we regularly evaluate our stores and the necessity to record expenses under SFAS No. 146.

*Operating Leases*

We lease stores under operating leases. Store lease agreements often include rent holidays, rent escalation clauses and contingent rent provisions for percentage of sales in excess of specified levels. Most of our lease agreements include renewal periods at our option. We recognize rent holiday periods and scheduled rent increases on a straight-line basis over the lease term beginning with the date we take possession of the leased space. We record

tenant improvement allowances and rent holidays as deferred rent liabilities on our consolidated balance sheets and amortize the deferred rent over the term of the lease to rent expense on our consolidated statements of operations. We record rent liabilities on our consolidated balance sheets for contingent percentage of sales lease provisions when we determine that it is probable that the specified levels will be reached during the fiscal



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year. We record direct costs incurred to effect a lease in other long-term assets and amortize these costs on a straight-line basis over the lease term beginning with the date we take possession of the leased space.

***Deferred Tax Assets***

A deferred income tax asset or liability is established for the expected future consequences resulting from temporary differences in the financial reporting and tax bases of assets and liabilities. As of July 2, 2005, we recorded a full valuation allowance against accumulated deferred tax assets of \$4.3 million due to the uncertainties regarding the realization of deferred tax assets primarily based on our cumulative loss position over the past three years. If we begin to generate taxable income in a future period or if the facts and circumstances on which our estimates and assumptions are based were to change, thereby impacting the likelihood of realizing the deferred tax assets, judgment would have to be applied in determining the amount of valuation allowance no longer required. Reversal of all or a part of this valuation allowance could have a significant positive impact on our net income in the period that it becomes more likely than not that certain of our deferred tax assets will be realized.

**Recently Issued Accounting Pronouncements**

During fiscal year 2004, we adopted EITF 03-10, *Application of Issue 02-16 by Resellers to Sales Incentives Offered to Consumers by Manufacturers*, which amends EITF 02-16. According to the amended guidance, if certain criteria are met, consideration received by a reseller in the form of reimbursement from a vendor for honoring the vendor's sales incentives offered directly to consumers (for example, manufacturers' coupons) should not be recorded as a reduction of the cost of the reseller's purchases from the vendor. The adoption of EITF 03-10 did not impact our financial condition, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (Revised), *Share-Based Payment* (SFAS No. 123 (R)), which replaces SFAS No. 123 and supercedes Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. Under the new standard, companies will no longer be able to account for share-based compensation transactions using the intrinsic method in accordance with APB No. 25. Instead, companies will be required to account for such transactions using a fair-value method and recognize the expense in the consolidated statement of income. SFAS 123(R) is effective as of the beginning of the first interim or annual reporting period that begins after December 15, 2005. SFAS 123(R) applies to all awards granted after the required effective date, but does not apply to awards granted in periods before the required effective date because we use the minimum value method, except if prior awards are modified, repurchased or cancelled after the effective date. We will adopt SFAS No. 123(R) on January 1, 2006. The impact of the adoption of SFAS 123(R) cannot be predicted at this time because it will depend on levels of share-based payments granted in the future. However, valuation of employee stock options under SFAS 123(R) is similar to SFAS 123, with minor exceptions. For information about what our reported results of operations would have been had we adopted SFAS 123, see the discussion in Note 2 to our unaudited consolidated financial statements included in Part I, Item 1, Financial Statements.

In December 2004, the FASB issued SFAS 153, *Exchanges of Nonmonetary Assets - an amendment of APB Opinion No. 29* (SFAS 153). The guidance in APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. The guidance in APB Opinion No. 29, however, included certain exceptions to that principle. SFAS 153 amends APB Opinion No. 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS 153 is effective for nonmonetary asset exchanges in fiscal periods beginning after June 15, 2005. We do not believe that the adoption of SFAS 153 will have a material impact on our financial condition, results of operations or cash flows.

**Results of Operations*****Three Months Ended July 2, 2005 Compared to Three Months Ended July 3, 2004***

We had net revenues of \$102.5 million, operating income of \$9.0 million and net income of \$6.0 million in the three months ended July 2, 2005 compared to net revenues of \$96.9 million, operating income of \$6.4 million and net income of \$2.3 million in the three months ended July 3, 2004.

The \$5.6 million increase in net revenues from the three months ended July 3, 2004 to the three months ended July 2, 2005 was mostly comprised of a \$6.9 million increase in non-comparable store net revenues offset by a decrease in comparable store

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revenues of \$0.4 million, or 0.5%, a decrease in direct-to-consumer channel revenues of \$0.4 million, or 1.5%, and a decrease in international revenues of \$0.5 million, or 25.1%. In comparison, comparable store revenues for the three months ended July 3, 2004 increased by \$0.3 million, or 0.7%. We believe the decrease in comparable store net revenues from the three months ended July 3, 2004 to the three months ended July 2, 2005 was due to increased competition in select markets, offset by a 1.0% increase in the number of golf rounds played in the U.S. during the three months ended June 30, 2005 as compared to the same period in 2004, as reported by Golf Datatech. Non-comparable store net revenues primarily include revenues from eight stores in operation that were opened subsequent to July 3, 2004 and three stores that became comparable during the quarter but which contributed \$1.0 million in non-comparable store net revenues during the quarter. The decrease in direct-to-consumer channel revenues was primarily due to planned reductions in catalog circulation intended to improve direct-to-consumer channel profitability. The decrease in international net revenues was primarily due to the sale of the rights to a trademark in fiscal 2004. Sales of products using this trademark contributed approximately one-third of international net revenues during the three months ended July 3, 2004 but did not contribute any international net revenues during the three months ended July 2, 2005.

For the three months ended July 2, 2005, gross profit was \$37.8 million, or 36.9% of net revenues, compared to \$33.4 million, or 34.4% of net revenues, for the three months ended July 3, 2004. Increased net revenues for the three months ended July 2, 2005 compared to the three months ended July 3, 2004 led to higher gross profit for the three months ended July 2, 2005. The increase in gross margin percentage was primarily due to increases in vendor allowances, which resulted in higher margins, and to us realizing economies of scale due to continued retail store growth, which has allowed us to purchase products in higher volumes with more favorable pricing.

Selling, general and administrative expenses increased \$1.1 million to \$28.0 million for the three months ended July 2, 2005 from \$26.9 million for the three months ended July 3, 2004. Increased selling, general and administrative expenses for the three months ended July 2, 2005 compared to the three months ended July 3, 2004 resulted from an increase in expenses of \$2.6 million related to general operations for non-comparable retail stores, offset by a decrease of \$1.3 million related to general operations for existing retail stores and a decrease of \$0.2 million related to general operations for corporate and international expenses.

Store pre-opening costs include costs associated with hiring and training personnel, supplies and occupancy and miscellaneous costs related to new store openings and are expensed as incurred. During the three months ended July 2, 2005, we incurred \$0.9 million in store pre-opening expenses related to the opening of three new retail locations and the opening of two new retail locations during the third fiscal quarter of 2005. During the three months ended July 3, 2004, we incurred \$0.1 million in store pre-opening expenses related to residual costs from the opening of four new retail locations during the first quarter of fiscal 2004.

Interest expense consists of costs related to Golfsmith's 8.375% senior secured notes and our senior credit facility with a financial institution. Interest expense was \$2.9 million and \$2.8 million for the three months ended July 2, 2005 and July 3, 2004, respectively. For further discussion, see [Liquidity and Capital Resources](#) [Senior Secured Notes](#) and [Liquidity and Capital Resources](#) [Credit Facility](#) below.

We record income taxes, consisting of federal, state and foreign taxes, based on the effective rate expected for the fiscal year. Actual results may differ from these estimates. We did not record federal income tax expense for the three months ended July 2, 2005 due to a full valuation allowance being recorded. Income tax expense of \$0.1 million during the three months ended July 2, 2005 represents foreign income tax expense. Income tax expense was \$1.3 million, or 37.3% of pre-tax net income, for the three months ended July 3, 2004.

***Six Months Ended July 2, 2005 Compared to Six Months Ended July 3, 2004***

We had net revenues of \$166.5 million, operating income of \$9.8 million and net income of \$4.0 million in the six months ended July 2, 2005 compared to net revenues of \$162.7 million, operating income of \$8.9 million and net income of \$2.1 million in the six months ended July 3, 2004.

The \$3.8 million increase in net revenues from the six months ended July 3, 2004 to the six months ended July 2, 2005 was mostly comprised of a \$11.1 million increase in non-comparable store revenues offset by a decrease in comparable store revenues of \$3.6 million, or 3.4%, a decrease in direct-to-consumer channel revenues of \$2.6 million, or 5.4%, and a decrease in international revenues of \$1.1 million, or 28.2%. In comparison, comparable

store revenues for the six months ended July 3, 2004 increased by \$6.4 million, or 8.7%. We believe the decrease in comparable store net revenues from the six months ended July 3, 2004 to the six months ended July 2, 2005 was due to increased competition in select markets and was influenced by the 1.3% decrease in the number of golf rounds played in the U.S. during the six months ended June 30, 2005 as compared to the same period in 2004, as reported by Golf Datatech. Non-comparable store net revenues primarily include revenues from eight stores in operation that were opened subsequent to July 3, 2004 and five stores that became comparable during the six months ended July 2,

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2005, but which contributed \$4.2 million in non-comparable store net revenues during the six months ended July 2, 2005. The decrease in direct-to-consumer channel revenues was primarily due to planned reductions in catalog circulation intended to improve direct-to-consumer channel profitability. The decrease in international net revenues was primarily due to the sale of the rights to a trademark in fiscal 2004. Sales of products using this trademark contributed approximately one-third of international net revenues during the six months ended July 3, 2004 but did not contribute any international net revenues during the six months ended July 2, 2005.

For the six months ended July 2, 2005, gross profit was \$60.6 million, or 36.4% of net revenues, compared to \$56.3 million, or 34.6% of net revenues, for the six months ended July 3, 2004. Increased net revenues for the six months ended July 2, 2005 compared to the six months ended July 3, 2004 led to higher gross profit for the six months ended July 2, 2005. The increase in gross margin percentage was primarily due to increases in vendor allowances, which resulted in higher margins, and to us realizing economies of scale due to continued retail store growth, which has allowed us to purchase products in higher volumes with more favorable pricing.

Selling, general and administrative expenses increased \$2.3 million to \$49.4 million for the six months ended July 2, 2005 from \$47.1 million for the six months ended July 3, 2004. Increased selling, general and administrative expenses for the six months ended July 2, 2005 compared to the six months ended July 3, 2004 resulted from an increase in expenses of \$4.7 million related to general operations for non-comparable retail stores and an increase of \$0.2 million related to general operations for corporate and international expenses, offset by a decrease of \$2.6 million related to general operations for existing retail stores.

Store pre-opening costs include costs associated with hiring and training personnel, supplies and occupancy and miscellaneous costs related to new store openings and are expensed as incurred. During the six months ended July 2, 2005, we incurred \$1.4 million in store pre-opening expenses related to the opening of four new retail locations and the opening of two new retail locations during the third fiscal quarter of 2005. During the six months ended July 3, 2004, we incurred \$0.4 million in store pre-opening expenses related to the opening of four new retail locations.

Interest expense consists of costs related to Golfsmith's 8.375% senior secured notes and our senior credit facility with a financial institution. Interest expense was \$5.8 million and \$5.6 million for the six months ended July 2, 2005 and July 3, 2004, respectively. For further discussion, see [Liquidity and Capital Resources](#) [Senior Secured Notes](#) and [Liquidity and Capital Resources](#) [Credit Facility](#) below.

We record income taxes, consisting of federal, state and foreign taxes, based on the effective rate expected for the fiscal year. Actual results may differ from these estimates. We did not record federal income tax expense for the six months ended July 2, 2005 due to a full valuation allowance being recorded. Income tax expense of \$0.1 million during the six months ended July 2, 2005 represents foreign income tax expense. Income tax expense was \$1.2 million, or 37.2% of pre-tax net income, for the six months ended July 3, 2004.

**Liquidity and Capital Resources****Cash Flows**

As of July 2, 2005, we had \$5.8 million in cash and cash equivalents, working capital of \$23.0 million and outstanding debt obligations of \$81.8 million. We had \$11.3 million in borrowing availability under our credit facility as of July 2, 2005, after giving effect to required reserves of \$500,000.

*Operating activities*

Net cash used in operating activities was \$2.7 million for the six months ended July 2, 2005, compared to net cash provided by operating activities of \$7.9 million for the six months ended July 3, 2004.

The increase in net cash used in operating activities of \$10.6 million from the six months ended July 3, 2004 to the six months ended July 2, 2005 was principally due to an increase in cash outflow of \$17.2 million for the purchase of inventory, offset by a decrease in cash outflow of \$4.5 million for payments of accounts payable and an increase in our net income of \$1.9 million. The increase in cash used in operating activities of \$17.2 million related to inventory was primarily the result of an increase in the number of retail superstores, from 42 stores as of July 3, 2004 to 49 stores as of July 2, 2005, and the related increase in inventory stock. Additionally, strategic initiatives to optimize inventory levels in our retail locations combined with additive inventory for tennis product and apparel increased inventory levels and the cash requirements to fund the increased inventory levels. The increases in cash provided by operating activities of \$4.5 million related to accounts payable was primarily related to the timing of payments on

account.

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Net cash used in investing activities was \$6.9 million for the six months ended July 2, 2005, compared to net cash used in investing activities of \$4.0 million for the six months ended July 3, 2004. Net cash used in investing activities for the six months ended July 2, 2005 and July 3, 2004 were almost entirely the result of capital expenditures for new and existing stores.

*Financing activities*

Net cash provided by financing activities was \$0.7 million for the six months ended July 2, 2005 and primarily consisted of proceeds from our senior credit facility, net of payments, compared to net cash used in financing activities of \$1.4 million for the six months ended July 3, 2004. Net cash used in financing activities for the six months ended July 3, 2004 of \$1.4 million was comprised primarily of payments on our senior credit facility of \$1.4 million, net of proceeds from borrowings.

**Senior Secured Notes**

On October 15, 2002, Golfsmith completed a private placement of \$93.75 million aggregate principal amount at maturity of its 8.375% senior secured notes due 2009 for gross proceeds of \$75.0 million. In July 2003, Golfsmith conducted an exchange offer in which Golfsmith offered to exchange new senior secured notes registered under the Securities Act of 1933 for all of its eligible existing senior secured notes. The terms of the new notes are substantially identical as those issued in the private placement, except the new notes are freely tradable. We fully and unconditionally guarantee the notes. As a result of the covenants in the indenture governing the notes, our ability to borrow under the credit facility described below is restricted to a maximum of \$12.5 million, our capital expenditures are limited and the payment of dividends or repurchases of stock are limited. In March 2005, the indenture governing the senior secured notes was amended to revise the definition of capital expenditure basket to increase by \$5.0 million the capital expenditures that we are permitted to make during any given fiscal year.

Within 120 days after the end of each fiscal year, Golfsmith is required by the indenture governing the notes to offer to repurchase the maximum principal amount of notes that may be purchased with 50% of its excess cash flow from our previous fiscal year at a purchase price of 100% of the accreted value of the notes to be purchased. The indenture governing the notes defines excess cash flow as consolidated net income plus interest, amortization and depreciation expense, income taxes, and net non-cash charges, less certain capital expenditures, increases in working capital, cash interest expense and income taxes. As of the end of fiscal 2004, we determined that we did not have any excess cash flow, as defined in the indenture, and were thus not required to offer to repurchase any of the notes. We do not believe that the current fiscal year requirement will have a material impact on our liquidity.

**Credit Facility**

We have a revolving senior credit facility with borrowing availability of \$12.5 million (subject to required reserves of \$500,000), subject to customary conditions, to fund our working capital requirements and for general corporate purposes. The senior credit facility expires in April 2007. Three of our subsidiaries are borrowers under the senior credit facility and we, Golfsmith and our other subsidiaries fully and unconditionally guarantee the senior credit facility. Borrowings under our credit facility are secured by a pledge of our inventory, receivables, and certain other assets. The credit agreement provides for same-day funding of the revolver, as well as letters of credit up to a maximum of \$1 million. Borrowings under the credit facility may be made, at our option, as either an index rate loan or a LIBOR rate loan. Index rate loans bear interest at the higher of (1) the Wall Street Journal posted base rate on corporate loans or (2) the federal funds rate, in each case plus 1%. LIBOR rate loans bear interest at a rate based on LIBOR plus 2.5%. A fee of 2.5% per annum of the amount available under outstanding letters of credit is due and payable monthly. We are also required to pay a monthly commitment fee equal to 0.5% of the undrawn availability, as calculated under the agreement.

Available amounts under the senior credit facility are based on a borrowing base. The borrowing base is limited to 85% of the net amount of eligible receivables, as defined in the credit agreement, plus the lesser of (i) 65% of the value of eligible inventory and (ii) 60% of the net orderly liquidation value of eligible inventory, and minus \$2.5 million, which is an availability block used to calculate the borrowing base.

In March 2005, several financial covenants in the senior credit facility were amended. The limit on capital expenditures in each fiscal year was increased to the greater of (a) one-third of our EBITDA (as defined in the senior

credit facility) in the immediately preceding fiscal year and (b) the sum of: (i) \$12.0 million, (ii) the amount, if any, of the excess cash flow offer (as described above under Liquidity and Capital Resources Senior Secured Notes ) made and not accepted by the holders of the senior secured notes during the immediately preceding fiscal year, and (iii) any amounts, up to an aggregate of \$1,000,000, previously permitted



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to be made as capital expenditures that have not previously been made as capital expenditures. In addition, the covenants regarding minimum interest coverage ratios and minimum earnings levels were removed for the fiscal period ending on or about September 30, 2004 and all fiscal periods thereafter. Finally, the definition of borrowing base in the senior credit facility was amended to include an availability block of \$2.5 million, as used to calculate the borrowing base under the senior credit facility.

Due to our accelerated growth plans, we believe that the modification of the capital expenditure limit better matches our currently projected cash needs. We do not believe that the addition of the availability block described above will materially impact our borrowing availability in fiscal 2005. As of July 2, 2005, we had \$0.7 million in borrowings outstanding under the credit agreement and we believe we were in compliance with the covenants contained in the senior credit facility.

Borrowings under our senior credit facility typically increase as working capital increases in anticipation of the important selling periods in late spring and in advance of the Christmas holiday, and then decline following these periods. In the event sales results are less than anticipated and our working capital requirements remain constant, the amount available under the credit facility may not be adequate to satisfy our needs. If this occurs, we may not succeed in obtaining additional financing in sufficient amounts and on acceptable terms.

**Capital Expenditures**

Subject to our ability to generate sufficient cash flow, in fiscal year 2005 we currently plan to spend \$11.0 million to \$13.0 million on corporate projects, to open additional stores and/or to retrofit, update or remodel existing stores, of which \$6.9 million was expended during the six months ended July 2, 2005.

**Contractual Obligations**

Our future contractual obligations related to long-term debt, noncancellable operating leases and purchase obligations at July 2, 2005 are as follows:

Contractual Obligations	Total	Payments Due by Period			After 5 Years
		Less than 1 Year	1-3 Years (in thousands)	4-5 Years	
Long-term debt <sup>(1)</sup>	\$ 93,750	\$	\$ 18,750	\$ 75,000	\$
Operating leases	\$ 129,443	\$ 15,753	\$ 31,104	\$ 27,461	\$ 55,125
Purchase obligations <sup>(2)</sup>	\$ 4,568	\$ 3,578	\$ 590	\$ 400	\$
<b>Total</b>	<b>\$ 227,761</b>	<b>\$ 19,331</b>	<b>\$ 50,444</b>	<b>\$ 102,861</b>	<b>\$ 55,125</b>

(1) Long-term debt represents principal payments required to be made on the senior secured notes. Interest payments on the notes are required semi-annually and are calculated at 8.375% of the

aggregate  
principal  
amount at  
maturity of  
notes then  
outstanding.

- (2) Purchase obligations consist of minimum royalty payments and services and goods we are committed to purchase in the ordinary course of business. Purchase obligations do not include contracts we can terminate without cause with little or no penalty to us.

We expect that our principal uses of cash for the next several years will be interest payments on the senior secured notes and our senior credit facility, capital expenditures, primarily for new store openings and existing store updates and remodels, possible acquisitions (to the extent permitted by the lenders under our senior credit facility and under the indenture governing the notes), working capital requirements and our contractually obligated operating lease payments. We expect to spend approximately \$1.5 million to open each additional superstore, which includes pre-opening expenses, capital expenditures and inventory costs. Additionally, Golfsmith is required to (1) offer to repurchase a portion of the senior secured notes at 100% of their accreted value within 120 days after the end of each fiscal year with 50% of our excess cash flow, as defined in the indenture governing the senior secured notes, and (2) under certain circumstances, purchase senior secured notes at 101% of their accreted value plus accrued and unpaid interest, if any, to the date of purchase. As of the end of fiscal 2004, we determined that we did not have any excess cash flow, as defined in the indenture, and we were thus not required to offer to repurchase any of the notes. We believe that cash from operations combined with borrowing availability under our senior credit facility will be sufficient to meet our expected debt service requirements, planned capital expenditures and operating needs. However, we have limited ability to obtain additional debt

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financing to fund working capital needs and capital expenditures should cash from operations and from our senior credit facility be insufficient. As of July 2, 2005, we had \$11.3 million of borrowing availability under the senior credit facility after giving effect to required reserves of \$500,000. We believe that the financial support of our principal stockholder and the use of our senior credit facility offer us potential funding avenues to meet working capital requirements. Further, we believe discretionary cash outflows related to new store openings, store retrofittings, advertising and capital expenditures can be adjusted accordingly if needed to meet working capital requirements. If cash from operations and from our senior credit facility is not sufficient to meet our needs, we cannot assure you that we will be able to obtain additional financing in sufficient amounts and on acceptable terms. You should read the information set forth below under **Additional Factors That May Affect Future Results** for a discussion of the risks affecting our operations.

**Off-Balance Sheet Arrangements**

We do not have any off-balance sheet arrangements, as defined by the rules and regulations of the Securities and Exchange Commission.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We are exposed to market risks, which include changes in U.S. interest rates and, to a lesser extent, foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

*Interest Rate Risk*

The interest payable on our senior credit facility is based on variable interest rates and is therefore affected by changes in market interest rates. As of July 2, 2005, if the maximum available under the credit facility of \$12.5 million had been drawn and the variable interest rate applicable to our variable rate debt had increased by ten percentage points, our interest expense would have increased by \$1.25 million on an annual basis, thereby materially affecting our results from operations and cash flows. Our interest rate risk objectives are to limit the impact of interest rate fluctuations on earnings and cash flows and to lower our overall borrowing costs. To achieve these objectives, we manage our exposure to fluctuations in market interest rate for a portion of our borrowings through the use of fixed rate debt instruments to the extent that reasonably favorable rates are obtainable with such arrangements. We may enter into derivative financial instruments such as interest rate swaps or caps and treasury options or locks to mitigate our interest rate risk on a related financial instrument or to effectively fix the interest rate on a portion of our variable rate debt. Currently, we are not a party to any derivative financial instruments. We do not enter into derivative or interest rate transactions for speculative purposes. We regularly review interest rate exposure on our outstanding borrowings in an effort to minimize the risk of interest rate fluctuations.

*Foreign Currency Risks*

We purchase a significant amount of products from outside of the U.S. However, these purchases are primarily made in U.S. dollars and only a small percentage of our international purchase transactions are in currencies other than the U.S. dollar. Any currency risks related to these transactions are deemed to be immaterial to us as a whole.

We operate a fulfillment center in Toronto, Canada and a sales, marketing and fulfillment center near London, England, which exposes us to market risk associated with foreign currency exchange rate fluctuations. At this time, we do not manage the risk through the use of derivative instruments. A 10% adverse change in foreign currency exchange rates would not have a significant impact on our results of operations or financial position.

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**FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. Statements that are not historical facts, including statements about our beliefs and expectations, are forward-looking statements. Forward-looking statements include statements preceded by, followed by or that include the words may, could, would, should, believe, expect, anticipate, plan, estimate, target, project, expressions. These statements include, among others, statements regarding our expected business outlook, anticipated financial and operating results, our business strategy and means to implement the strategy, our objectives, the amount and timing of future store openings, store retrofits and capital expenditures, the likelihood of our success in expanding our business, financing plans, working capital needs and sources of liquidity.

Forward-looking statements are only predictions and are not guarantees of performance. These statements are based on our management's beliefs and assumptions, which in turn are based on currently available information. Important assumptions relating to the forward-looking statements include, among others, assumptions regarding demand for our products, the introduction of new product offerings, store opening costs, our ability to lease new sites on a timely basis, expected pricing levels, the timing and cost of planned capital expenditures, competitive conditions and general economic conditions. These assumptions could prove inaccurate. Forward-looking statements also involve risks and uncertainties, which could cause actual results that differ materially from those contained in any forward-looking statement. Many of these factors are beyond our ability to control or predict. Such factors include, but are not limited to, the factors set forth below under Additional Factors That May Affect Future Results.

We believe our forward-looking statements are reasonable; however, undue reliance should not be placed on any forward-looking statements, which are based on current expectations. Further, forward-looking statements speak only as of the date they are made, and we undertake no obligation to update publicly any of them in light of new information or future events.

**Table of Contents****Additional Factors That May Affect Future Results**

***Our success depends on the continued popularity of golf and the growth of the market for golf-related products. If golf declines in popularity, our sales could materially decline.***

We generate substantially all of our net revenues from the sale of golf-related equipment, apparel and accessories. The demand for our golf products is directly related to the popularity of golf, the number of golf participants and the number of rounds of golf being played by these participants. If golf participation decreases, sales of our products would be adversely affected. In addition, the popularity of golf organizations, such as the Professional Golfers Association, also affects the sales of our golf equipment and golf-related apparel and accessories. We depend on the exposure of our brands to increase brand recognition and reinforce the quality of our products. Any significant reduction in television coverage of PGA or other golf tournaments, or any other significant decreases in either attendance at golf tournaments or viewership of golf tournaments, will reduce the visibility of our brand and could adversely affect our sales.

In addition, we do not believe there has been any material increase in golf participation or the number of golf rounds played since 1999. The number of rounds played in the U.S. dropped to 495 million in 2003 from 518 million in 2000, perhaps reflecting the general decline in the U.S. economy. We believe that the golf industry did not experience growth in 2004. Golf Datatech has reported that the number of golf rounds played in the United States declined 0.1% in 2004 as compared to 2003. Additionally, Golf Datatech has reported that the number of golf rounds played in the United States declined 1.3% in the six months ended June 30, 2005 as compared to the same period in 2004. We cannot assure you that the overall dollar volume of the worldwide market for golf-related products will grow, or that it will not decline, in the future.

***We may not be able to borrow additional funds, if needed, to expand our business or compete effectively and, as a result, our net revenues and profitability may be materially adversely affected.***

The indenture governing the senior secured notes and our senior credit facility limit almost completely our ability to borrow additional funds. We believe that the terms of the liens securing our senior credit facility and the senior secured notes effectively preclude us from borrowing additional funds, other than under our senior credit facility. As a result, to the extent that we do not have borrowing availability under our senior credit facility, we will have to fund our operations, including new store openings and capital expenditures as well as any future acquisitions, with cash flow from operations. If we do not generate sufficient cash flow from our operations to fund these expenditures, we may not be able to compete effectively and our sales and profitability would likely be materially adversely affected.

***A reduction in discretionary consumer spending could reduce sales of our products.***

Our products are recreational in nature and are therefore discretionary purchases for consumers. Consumers are generally more willing to make discretionary purchases of golf and tennis products during favorable economic conditions. Discretionary spending is affected by many factors, including, among others, general business conditions, interest rates, the availability of consumer credit, taxation, and consumer confidence in future economic conditions. Our customers' purchases of discretionary items, including our products, could decline during periods when disposable income is lower, or periods of actual or perceived unfavorable economic conditions. Any significant decline in these general economic conditions or uncertainties regarding future economic prospects that adversely affect discretionary consumer spending could lead to reduced sales of our products. In addition, our sales could be adversely affected by a downturn in the economic conditions in the markets in which our superstores operate.

***Our sales and profits may be adversely affected if we and our suppliers fail to successfully develop and introduce new products.***

Our future success will depend, in part, upon our and our suppliers' continued ability to develop and introduce innovative products in the golf equipment market. The success of new products depends in part upon the various subjective preferences of golfers, including a golf club's look and feel, and the level of acceptance that a golf club has among professional and recreational golfers. The subjective preferences of golf club purchasers are difficult to predict and may be subject to rapid and unanticipated changes. If we or our suppliers fail to successfully develop and introduce innovative products on a timely basis, then our sales and profits may suffer.

In addition, if we or our suppliers introduce new golf clubs too rapidly, it could result in close-outs of existing inventories. Close-outs can result in reduced margins on the sale of older products, as well as reduced sales of new

products given the availability of older products at lower prices. These reduced margins and sales may adversely affect our results of operations.

**Table of Contents*****Our sales and profitability may be adversely affected if new competitors enter the golf products industry.***

Increased competition in our markets due to the entry of new competitors, including companies which currently supply us with products that we sell, could reduce our net revenues. Our competitors currently include other specialty retailers, mass merchandise retailers, conventional sporting goods retailers, on-course pro shops, and online retailers of golf equipment. These businesses compete with us in one or more product categories. In addition, traditional and specialty golf retailers are expanding more aggressively in marketing brand-name golf equipment, thereby competing directly with us for products, customers and locations. Some of these potential competitors have been in business longer than we have and/or have greater financial or marketing resources than we do and may be able to devote greater resources to sourcing, promoting and selling their products. As a result of this competition, we may experience lower sales or greater operating costs, such as marketing costs, which would have an adverse effect on our profitability.

***New superstores that we may open may divert our limited capital resources away from other areas of our business and may not be profitable, which could adversely affect the profitability of our company as a whole.***

Our strategy involves opening additional superstores in new and existing markets. During the six months ended July 2, 2005, we opened four new stores, incurring \$0.8 million in related pre-opening expenses and \$2.4 million in related capital expenditures. We plan to open four additional stores during the remaining two quarters of fiscal 2005, one of which opened in July 2005 and one of which opened in August 2005. We expect to spend \$1.5 million to open each additional superstore, which includes pre-opening expenses, capital expenditures and inventory costs. This amount is an estimate and actual store opening costs may vary. We intend to fund new store openings through cash flow from operations. Our senior credit facility and the indenture governing our senior secured notes significantly restrict our ability to incur indebtedness and to make capital expenditures. We may not have or be able to obtain sufficient funds to fund our planned expansion.

Our ability to open new stores on a timely and profitable basis is subject to various contingencies, some of which are beyond our control. These contingencies include our ability to locate suitable store sites, negotiate acceptable lease terms, build-out or refurbish sites on a timely and cost-effective basis, hire, train and retain skilled managers and personnel, obtain adequate capital resources and successfully integrate new stores into existing operations. We cannot assure you that our new stores will be a profitable deployment of our limited capital resources. If any of our new stores are not profitable, then the profitability of our company as a whole may be adversely affected.

***Our expansion in new and existing markets, if unsuccessful, could cause our operating income to decrease.***

Our expansion in new and existing markets may present competitive, distribution, and merchandising challenges that differ from our current challenges, including competition among our stores clustered in a single market, diminished novelty of our store design and concept, added strain on our distribution center and management information systems and diversion of management attention from existing operations. To the extent that we are not able to meet these new challenges, our operating income could decrease.

***If we do not accurately predict our sales during our peak seasons and they are lower than we expect, our profitability may be materially adversely affected.***

Our business is seasonal. Our sales leading up to and during the warm weather golf season and the Christmas holiday gift-giving season have historically contributed a higher percentage of our annual net revenues and annual net operating income than other periods in our fiscal year. During fiscal 2004, the fiscal months of March through September and December, which together comprise 36 weeks of our 52-week fiscal year, contributed over three-quarters of our annual net revenues and substantially all of our annual operating income. We make decisions regarding merchandise well in advance of the season in which it will be sold. We incur significant additional expenses leading up to and during these periods in anticipation of higher sales in these periods, including acquiring additional inventory, preparing and mailing our catalogs, advertising, creating in-store promotions and hiring additional employees. If our sales during our peak seasons are lower than we expect for any reason, we may not be able to adjust our expenses in a timely fashion. As a result, our profitability may be materially adversely affected.

***If the products we sell do not satisfy the standards of the United States Golf Association and the Royal and Ancient Golf Club of St. Andrews in the future, our net revenues attributable to those products and our profitability may be reduced.***



We and our suppliers generally seek to satisfy the standards established by the United States Golf Association and the Royal and Ancient Golf Club of St. Andrews in the design of golf clubs because these standards are generally followed by golfers within their respective geographic areas. We believe that all of the products we sell conform to these standards, except where expressly marketed as non-conforming. However, we cannot assure you that our products will satisfy these standards in the future or that the

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standards of these organizations will not be changed in a way that makes our products non-conforming. If our products that are intended to conform are determined to be non-conforming, our net revenues attributable to those products and, as a result, our profitability may be reduced.

***We lease most of our superstore locations. If we are unable to maintain those leases or locate alternative sites for our superstores on terms that are acceptable to us, our net revenues and profitability could be reduced.***

We lease 50 of our 51 current superstores. In the six months ended July 2, 2005, we closed one store when its lease expired. In August 2005, we opened a new superstore in order to serve the same customer base of the closed store. We cannot assure you that we will be able to maintain our existing store locations as leases expire, or that we will be able to locate alternative sites on favorable terms. If we cannot maintain our existing store locations or locate alternative sites on favorable or acceptable terms, our net revenues and profitability could be reduced.

***Our comparable store sales may fluctuate, which could negatively impact our future operating performance.***

Our comparable store sales are affected by a variety of factors, including, among others:  
customer demand in different geographic regions;

our ability to efficiently source and distribute products;

changes in our product mix;

promotional events;

effects of competition;

our ability to effectively execute our business strategy; and

general economic conditions.

Our comparable store sales have fluctuated significantly in the past and we believe that such fluctuations may continue. Our historic results are not necessarily indicative of our future results, and we cannot assure you that our comparable store sales will not decrease again in the future. Any reduction in or failure to increase our comparable store sales could negatively impact our future operating performance.

***If we fail to accurately target the appropriate segment of the consumer catalog market or if we fail to achieve adequate response rates to our catalogs, our results of operations may suffer.***

Our results of operations depend in part on the success of our direct-to-consumer distribution channels, which consist of our catalog and Internet operations. Our direct-to-consumer distribution channels accounted for approximately 27.7% and 29.2% of our net revenues for the six-month periods ended July 2, 2005 and July 3, 2004, respectively. Within our direct-to-consumer distribution channels, the success of our catalog operations also contributes to the success of our Internet operations, as many of our customers who receive catalogs choose to purchase products through our website. We believe that the success of our catalog and Internet operations depends on our ability to:

achieve adequate response rates to our mailings;

continue to offer a merchandise mix that is attractive to our mail order customers;

cost-effectively add new customers;

cost-effectively design and produce appealing catalogs; and

timely deliver products ordered through our catalogs to our customers.

We have historically experienced fluctuations in the response rates to our catalog mailings. If we fail to achieve adequate response rates, we could experience lower sales, significant markdowns or write-offs of inventory and lower

margins, which would adversely affect our results of operations, perhaps materially.

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***If we are unable to meet our labor needs, our performance will suffer.***

Many of our employees are in entry-level or part-time positions that historically have high rates of turnover. We may be unable to meet our labor needs and control our costs due to external factors such as unemployment levels, minimum wage legislation, and wage inflation. If we cannot attract and retain quality employees, our performance will suffer and we may not be able to successfully execute our strategy to open new superstores.

***If we lose the services of our chief executive officer, we may not be able to manage our operations and implement our growth strategy effectively.***

Our future success depends, in large part, on the continued service of James Thompson, our president and chief executive officer, who possesses significant expertise and knowledge of our business and markets. We do not maintain key person insurance on any of our officers or managers. We have entered into an employment agreement with Mr. Thompson which expires, subject to automatic one-year extensions, in October 2005. Any loss or interruption of the services of Mr. Thompson prior to or upon expiration of his employment agreement could significantly reduce our ability to effectively manage our operations and implement our growth strategy because we cannot assure you that we would be able to find an appropriate replacement should the need arise.

***We are controlled by one stockholder, which may give rise to a conflict of interest.***

As of July 2, 2005, Atlantic Equity Partners III, L.P. owned approximately 73.8% of our common stock on a fully diluted basis, including outstanding stock options. All of our stockholders are parties to a stockholders agreement that contains voting arrangements that give Atlantic Equity Partners III voting control over the election of all but one of our directors. As a result, Atlantic Equity Partners III controls us and effectively has the power to approve any action requiring the approval of the holders of our stock, including adopting certain amendments to our certificate of incorporation and approving mergers or sales of all of our assets. In addition, as a result of Atlantic Equity Partners III's ownership interest, conflicts of interest could arise with respect to transactions involving business dealings between us and Atlantic Equity Partners III or First Atlantic Capital Ltd., which operates Atlantic Equity Partners III, potential acquisitions of businesses or properties, the issuance of additional securities, the payment of dividends by us and other matters.

***If we are unable to enforce our intellectual property rights, or if we are accused of infringing on a third party's intellectual property rights, our net revenues and profits may decline.***

We currently hold a substantial number of registrations, trademarks and servicemarks. The exclusive right to use these registrations, trademarks and servicemarks has helped establish our market share. Our registrations are valid as long as they are properly maintained and the registered marks have not become generic or abandoned or the registrations obtained fraudulently. Our trademarks and servicemarks are generally valid as long as they are properly in use in commerce. The loss or reduction of any of our significant proprietary rights could hurt our ability to distinguish our products from competitors' products and retain our market share. In addition, our proprietary products generate higher margins than products we sell that are produced by other manufacturers. If we are unable to effectively protect our proprietary rights and less of our sales come from our proprietary products, our net revenues and profits may decline.

Additionally, third parties may assert claims against us alleging infringement, misappropriation or other violations of patent, trademark or other proprietary rights, whether or not such claims have merit. Such claims can be time consuming and expensive to defend and could require us to cease using and selling the allegedly infringing products, which may have a significant impact on our net revenues and cause us to incur significant litigation costs and expenses.

***Self-insured benefits plan claims could materially impact our results of operations.***

We administer self-insured, voluntary employee benefits plans that provide, among other benefits, health care benefits to participating employees. The plans are designed to provide specified levels of coverage up to \$75,000 per covered employee, with excess insurance coverage provided by a commercial insurer. Costs of health care have risen significantly in recent years, and we expect this trend to continue. Our expenses and, consequently, our results of operations, could be materially impacted by claims and other expenses related to such plans.

***We rely on our management information systems for inventory management, distribution and other functions. If our information systems fail to adequately perform these functions or if we experience an interruption in their***

*operation, our business and results of operations could be adversely affected.*

The efficient operation of our business is dependent on our management information systems. We rely on our management

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information systems to effectively manage order entry, order fulfillment, point-of-sale, and inventory replenishment processes. We experienced implementation problems with our current management information system in 2000, when slowdowns in or lack of availability to the system resulted in decreased sales, increased overhead costs, excess inventory and product shortages. The failure of our management information systems to perform as we anticipate, as experienced when we implemented our current system in 2000, could disrupt our business and could result in decreased sales, increased overhead costs, excess inventory and product shortages, causing our business and results of operations to suffer.

In addition, our management information systems are vulnerable to damage or interruption from: earthquake, fire, flood and other natural disasters; and

power loss, computer systems failure, Internet and telecommunications or data network failure.

Any such interruption could have a material adverse effect on our business.

***Our profitability would be adversely affected if the operation of our Austin call center or distribution center were interrupted or shut down.***

We operate a centralized call center and distribution center in Austin, Texas. We receive most of our catalog orders and receive and ship a substantial portion of our merchandise at our Austin facility. Any natural disaster or other serious disruption to this facility due to fire, tornado or any other cause would substantially disrupt our sales and would damage a portion of our inventory, impairing our ability to adequately stock our stores. In addition, we could incur significantly higher costs and longer lead times associated with fulfilling our direct-to-consumer orders and distributing our products to our stores during the time it takes for us to reopen or replace our Austin facility. As a result, a disruption at our Austin facility would adversely affect our profitability.

***If our suppliers fail to deliver products on a timely basis and in sufficient quantities, such failure could have a material adverse effect on our operations.***

We depend on a limited number of suppliers for our clubheads and shafts. In addition, some of our products require specifically developed manufacturing techniques and processes which make it difficult to identify and utilize alternative suppliers quickly. Any significant production delay or inability of current suppliers to timely deliver products including clubheads and shafts in sufficient quantities, or the transition to other suppliers, could have a material adverse effect on our results of operations. We do not have any long-term supply contracts with these suppliers.

We import substantially all of our proprietary products from Asia under short-term purchase orders, and a significant amount of the products we buy from vendors to resell through our distribution channels is shipped to us from Asia. If a disruption occurs in the operations of ports through which our products are imported, we may begin to ship some of our products from Asia by air freight, and many of our suppliers may also begin to ship their products by air freight. Shipping by air freight is more expensive than shipping by boat, and if we cannot pass these increased shipping costs on to our customers, our profitability will be reduced. A disruption at ports through which our products are imported would have a material adverse effect on our results of operations.

***We may be subject to product warranty claims or product recalls which could harm our business, results of operations, and reputation.***

We may be subject to risks associated with our products, including product liability. Our existing or future products may contain design or materials defects, which could subject us to product liability claims and product recalls. Although we maintain limited product liability insurance, if any successful product liability claim or product recall is not covered by or exceeds our insurance coverage, our business, results of operations and financial condition would be harmed. In addition, product recalls could adversely affect our reputation in the marketplace.

***An increase in the costs of mailing, paper, and printing our catalogs would decrease our net income.***

Postal rate increases and paper and printing costs affect the cost of our catalog mailings. We rely on discounts from the basic postal rate structure such as discounts for bulk mailings and sorting by zip code and carrier routes for our catalogs. We are not a party to any long-term contracts for the supply of paper. Our cost of paper has fluctuated significantly during the past three fiscal years, and our future paper costs are subject to supply and demand forces external to our business. A material increase in postal rates or printing or paper costs for our catalogs could materially

decrease our net income.

**Table of Contents*****A disruption in the service of our primary delivery service for our direct-to-consumer sales may decrease our profitability.***

During the six-month periods ended July 2, 2005 and July 3, 2004, we generated approximately 27.7% and 29.2%, respectively, of our net revenues through our direct-to-consumer sales channels. We use United Parcel Service, or UPS, for substantially all of our ground shipments of products sold through our catalogs and Internet site to our customers in the United States. Any significant interruption in UPS's services would impede our ability to deliver our products through our direct-to-consumer channels, which could cause us to lose sales and/or customers. In the event of an interruption in UPS's services, we may not be able to engage alternative carriers to deliver our products in a timely manner on equally favorable terms. If we incur higher shipping costs, we may be unable to pass these costs on to our customers, which could decrease our profitability.

***Current and future tax regulations may adversely affect our direct-to-consumer business and negatively impact our results of operations.***

Our direct-to-consumer business may be adversely affected by state sales and use taxes as well as the regulation of Internet commerce. We currently must collect taxes for approximately half of our catalog and Internet sales. An unfavorable change in state sales and use taxes could adversely affect our business and results of operations. In addition, future regulation of the Internet, including the imposition of taxes on Internet commerce, could affect the development of our Internet business and negatively affect our ability to increase our net revenues.

***If we do not anticipate and respond to the changing preferences of our customers, our revenues could significantly decline and we could be required to take significant markdowns in inventory.***

Our success depends, in large part, on our ability to identify and anticipate the changing preferences of our customers and stock our stores with a wide selection of quality merchandise that appeals to their preferences. Our customers' preferences for merchandise and particular brands vary from location to location, and may vary significantly over time. We cannot guarantee that we will accurately identify or anticipate the changing preferences of our customers or stock our stores with merchandise that appeals to them. If we do not accurately identify and anticipate our customers' preferences, we may lose sales or we may overstock merchandise, which may require us to take significant markdowns on our inventory. In either case, our revenues could significantly decline and our business and financial results may suffer.

***We may incur material costs or liabilities under environmental laws, which may materially adversely affect our results of operations.***

We are subject to various foreign, federal, state, and local environmental protection, chemical control, and health and safety laws and regulations. We own and lease real property, and some environmental laws hold current or previous owners or operators of businesses and real property liable for contamination on or originating from that property, even if they did not know of and were not responsible for the contamination. The presence of hazardous substances on any of our properties or the failure to meet environmental regulatory requirements may materially adversely affect our ability to use or to sell the property or to use the property as collateral for borrowing, and may cause us to incur substantial remediation or compliance costs. If hazardous substances are released from or located on any of our properties, we could incur substantial liabilities through a private party personal injury or property damage claim or a claim by a governmental entity for other damages.

In addition, some of the products we sell contain hazardous or regulated substances, such as solvents and lead. Environmental laws may impose liability on any person who disposes of hazardous substances, regardless of whether the disposal site is owned or operated by such person.

If we incur material costs or liabilities in the future under environmental laws for any reason, our results of operations may be materially adversely affected.

***Our sales could decline if we are unable to process increased traffic or our website or to prevent unauthorized security breaches.***

A key element of our strategy is to generate a high volume of traffic on, and use of, our website. Accordingly, the satisfactory performance, reliability and availability of our website, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain customers, as well as maintain adequate customer service levels. Our Internet revenues will depend on the number of visitors who shop on our website and the



volume of orders we can fill on a timely basis. Problems with our website or order fulfillment performance would reduce the volume of goods sold and the attractiveness of our merchandise and could also adversely affect consumer perception of our brand name. We may experience periodic system interruptions from time to time. If there is a substantial increase in the volume of traffic on our website or the number of orders

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placed by customers, we may be required to expand and upgrade further our technology, transaction processing systems and network infrastructure. There can be no assurance that we will be able to accurately project the rate or timing of increases, if any, in the use of our website, or that we will be able to expand and upgrade our systems and infrastructure to accommodate such increases on a timely basis.

The success of our website depends on the secure transmission of confidential information over public networks. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary to effect secure transmission of confidential information, such as customer credit card numbers. In addition, we maintain an extensive confidential database of customer profiles and transaction information. There can be no assurance that advances in computer capabilities, new discoveries in the field of cryptography, or other events or developments will not result in a compromise or breach of the algorithms we use to protect customer transaction and personal data contained in our customer database. If any such compromise of our security were to occur, it could have a material adverse effect on our reputation, business, operating results and financial condition. A party who is able to circumvent our security measures could misappropriate proprietary information or cause interruptions in our operations. We may be required to expend significant capital and other resources to protect against such security breaches or to alleviate problems caused by such breaches.

***We may pursue strategic acquisitions, which could have an adverse impact on our business.***

We intend to evaluate opportunities to acquire complementary companies or businesses in the future. Acquisitions that we may make in the future entail a number of risks that could materially and adversely affect our business and operating results, including:

problems integrating operations that have different personnel, corporate culture, financial systems, distribution, operations and general store operating procedures;

the diversion of capital and our management's time and attention from existing business operations;

risks associated with entering markets in which we lack prior experience; and

the need for financial resources above our planned investment levels.

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**Item 4. Controls and Procedures**

*Disclosure Controls and Procedures.* Under the supervision and with the participation of our management, including our principal executive officer and principal financial and accounting officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report (the Evaluation Date ). Based on this evaluation, our principal executive officer and principal financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to our company, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission ( SEC ) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial and accounting officer, as appropriate to allow timely decisions regarding required disclosure.

*Internal Control over Financial Reporting.* During the six months ended July 2, 2005, there have been no changes in our internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II: OTHER INFORMATION**

**Item 6. Exhibits**

- 10.1 Consulting agreement dated June 9, 2005, between Mr. Larry Mondry and Golfsmith International Holdings, Inc. (incorporated by reference to Exhibit 10.1 to Golfsmith International Holdings, Inc.'s Current Report on Form 8-K (File No. 333-101117) filed on June 14, 2005)
- 31.1 Rule 13a-14(a)/15d-14(a) Certification of James D. Thompson
- 31.2 Rule 13a-14(a)/15d-14(a) Certification of Virginia Bunte
- 32.1 Certification of James D. Thompson Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Virginia Bunte Pursuant to 18 U.S.C. Section 1350 as Adopted 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 registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

GOLFSMITH INTERNATIONAL  
HOLDINGS, INC.

By: /s/ James D. Thompson

James D. Thompson  
Chief Executive Officer, President and  
Director  
(Principal Executive Officer and Authorized  
Signatory)

Date: August 16, 2005

By: /s/ Virginia Bunte

Virginia Bunte  
Chief Financial Officer  
(Principal Accounting Officer and Authorized  
Signatory)

Date: August 16, 2005