GOLFSMITH INTERNATIONAL HOLDINGS INC
Form 10-Q
November 07, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-Q

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

For the quarterly period ended September 29, 2007

OR

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

For the transition period from__________ to

Commission file number 000-52041

GOLFSMITH INTERNATIONAL HOLDINGS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	16-1634847
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
11000 N. IH-35, Austin, Texas	78753
(Address of Principal Executive Offices)	(zip code)

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

Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report: Not Applicable

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 þ No o

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

Large accelerated filer o Accelerated filer o Non-accelerated filer þ

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No þ

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 November 1, 2007
$.001 par value	15,777,145 Shares

GOLFSMITH INTERNATIONAL HOLDINGS, INC.
QUARTERLY REPORT
FOR THE QUARTER ENDED SEPTEMBER 29, 2007

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

Golfsmith International Holdings, Inc.
Consolidated Balance Sheets

	September 29, 2007 (unaudited)	December 30, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 3,200,555	$ 1,801,631
Receivables, net of allowances of $204,733 at September 29, 2007 and $158,638 at December 30, 2006	1,839,599	1,387,786
Inventories	91,652,108	88,174,797
Prepaid and other current assets	7,754,439	9,938,863
Total current assets	104,446,701	101,303,077
Property and equipment:		
Land and buildings	21,492,375	21,433,166
Equipment, furniture and fixtures	31,322,156	25,181,495
Leasehold improvements and construction in progress	36,234,707	30,663,227
	89,049,238	77,277,888
Less: accumulated depreciation and amortization	(27,334,823)	(21,203,855)
Net property and equipment	61,714,415	56,074,033
Goodwill	42,557,370	42,557,370
Tradenames	11,158,000	11,158,000
Trademarks	14,064,189	14,064,189
Customer database, net of accumulated amortization of $1,888,447 at September 29, 2007 and $1,605,180 at December 30, 2006	1,510,758	1,794,025
Debt issuance costs, net of accumulated amortization of $164,601 at September 29, 2007 and $65,921 at December 30, 2006	597,565	533,088
Other long-term assets	401,729	435,568
Total assets	**$ 236,450,727**	**$ 227,919,350**
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 50,210,218	$ 51,944,778
Accrued expenses and other current liabilities	16,234,769	17,531,310
Line of credit	42,492,000	41,533,013
Total current liabilities	108,936,987	111,009,101
Deferred rent liabilities	10,628,367	6,799,142

Total liabilities	119,565,354	117,808,243
Stockholders Equity:		
Common stock $.001 par value; 100,000,000 shares authorized at September 29, 2007 and December 30, 2006, respectively; 15,777,145 and 15,722,598 shares issued and outstanding at September 29, 2007 and December 30, 2006, respectively	15,777	15,723
Preferred stock $.001 par value; 10,000,000 shares authorized at September 29, 2007 and December 30, 2006 respectively; no shares issued and outstanding		
Deferred Stock Units -$0.001 par value; 41,186 shares and 9,244 shares issued and outstanding at September 29, 2007 and December 30, 2006, respectively	41	9
Additional capital	120,906,379	120,079,008
Other comprehensive income	425,646	354,203
Accumulated deficit	(4,462,470)	(10,337,836)
Total stockholders equity	116,885,373	110,111,107
Total liabilities and stockholders equity	**$ 236,450,727**	**$ 227,919,350**

See accompanying notes to unaudited consolidated financial statements

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

	Three Months Ended		Nine Months Ended	
	September 29, 2007	**September 30, 2006**	**September 29, 2007**	**September 30, 2006**
Net revenues	$ 106,526,847	$ 93,980,075	$ 309,188,103	$ 282,928,686
Cost of products sold	68,705,865	61,608,658	200,841,230	183,053,628
Gross profit	37,820,982	32,371,417	108,346,873	99,875,058
Selling, general and administrative	32,605,293	28,383,552	97,569,728	86,249,248
Store pre-opening expenses	271,170	197,147	2,049,566	1,419,883
Total operating expenses	32,876,463	28,580,699	99,619,294	87,669,131
Operating income	4,944,519	3,790,718	8,727,579	12,205,927
Interest expense	(799,864)	(836,657)	(2,716,566)	(6,649,729)
Interest income	24,140	277,544	69,666	433,019
Other income	58,773	97,373	297,623	1,518,149
Other expense	(77,992)	(36,849)	(147,148)	(145,089)
Loss on debt extinguishment				(12,775,270)
Income (loss) before income taxes	4,149,576	3,292,129	6,231,154	(5,412,993)
Income tax (expense) benefit	(180,606)	76,974	(355,788)	(31,116)
Net income (loss)	**$ 3,968,970**	**$ 3,369,103**	**$ 5,875,366**	**$ (5,444,109)**
Basic net income (loss) per share of common stock	$ 0.25	$ 0.21	$ 0.37	$ (0.45)
Diluted net income (loss) per share of common stock	$ 0.25	$ 0.21	$ 0.37	$ (0.45)
Basic weighted average common shares outstanding	15,813,464	15,716,591	15,784,276	12,143,767
Diluted weighted average common shares outstanding	15,844,606	15,856,972	15,953,985	12,143,767

See accompanying notes to unaudited consolidated financial statements

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

	For the nine months ended September 29, 2007	September 30, 2006
Operating Activities		
Net income (loss)	$ 5,875,366	$ (5,444,109)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation	6,352,657	4,992,135
Amortization of intangible assets	283,267	283,267
Amortization of debt issue costs and debt discount	98,681	1,919,419
Loss on extinguishment of debt		12,775,270
Stock-based compensation	495,648	517,689
Payments of withholding taxes for stock unit conversions		(1,015,263)
Non-cash loss on write-off of property and equipment	17,179	165,791
Non-cash derivative income		(1,091,141)
Gain on sale of assets		(22,650)
Change in operating assets and liabilities:		
Accounts receivable	(451,813)	(7,490)
Inventories	(3,477,311)	(7,465,236)
Prepaids expenses and other current assets	2,349,850	(1,759,899)
Other assets	33,839	
Accounts payable	(1,734,560)	(1,287,951)
Accrued expenses and other current liabilities	(1,225,735)	(4,066,306)
Deferred rent	3,829,225	1,377,644
Net cash provided by (used in) operating activities	12,446,293	(128,830)
Investing Activities		
Capital expenditures	(12,435,829)	(12,155,215)
Proceeds from the sale of assets	190,000	22,650
Net cash used in investing activities	(12,245,829)	(12,132,565)
Financing Activities		
Principal payments on lines of credit	(136,575,074)	(87,546,469)
Proceeds from line of credit	137,534,061	130,764,469
Debt issuance costs	(163,158)	(464,009)
Payments to satisfy debt obligations		(94,431,896)
Proceeds from initial public offering, net		61,195,284
Proceeds from exercise of stock options	331,809	43,349
Net cash provided by financing activities	1,127,638	9,560,728
Effect of exchange rate changes on cash	70,822	129,389

Change in cash and cash equivalents	1,398,924	(2,571,278)
Cash and cash equivalents, beginning of period	1,801,631	4,207,497
Cash and cash equivalents, end of period	$ 3,200,555	$ 1,636,219
Supplemental cash flow information:		
Interest payments	$ 2,290,027	$ 7,767,387
Income tax payments	457,989	277,413
Supplemental non-cash transactions:		
Amortization of discount on senior secured notes		1,353,012
Write-off of debt issuance costs of senior secured notes and senior credit facility		4,200,425

See accompanying notes to unaudited consolidated financial statements

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1. Nature of Business and Basis of Presentation

Description of Business

Golfsmith International Holdings, Inc. (the Company) is a multi-channel, specialty retailer of golf and tennis equipment and related apparel and accessories. The Company offers golf and tennis equipment from top national brands as well as its own proprietary brands. In addition, the Company provides clubmaking services including the sale of individual club components for customers to build clubs as well as custom fitting and repair services. The Company markets its products through retail stores as well as through its Internet site and direct-to-consumer channels, which include its clubmaking and consumer catalogs. The Company also operates the Harvey Penick Golf Academy, a golf instruction school incorporating the techniques of the late Harvey Penick.

Basis of Presentation

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

The accompanying unaudited interim consolidated financial statements have been prepared in accordance with US generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Actual results could differ from those estimates. 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 necessary for a fair presentation of the Company s financial position, results of operations and cash flows for the periods presented. This includes all normal and recurring adjustments, but does not include all of the information and footnotes required by generally accepted accounting principles (GAAP) for complete financial statements. These consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto for the year ended December 30, 2006, included in the Company s Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on March 30, 2007. The results of operations for the three- and nine-month periods ended September 29, 2007 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 December 30, 2006 has been derived from the Company s audited consolidated financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the audited consolidated financial statements and notes thereto for the fiscal year ended December 30, 2006 included in the Company s Annual Report on Form 10-K filed with the SEC on March 30, 2007.

Revenue Subject to Seasonal Variations

The Company s business is seasonal and its sales leading up to and during the warm weather golf season and the December holiday gift-giving season have historically contributed a higher percentage of the Company s annual net revenues and annual net operating income than in other periods in its fiscal year. The months encompassing these seasons are responsible for the majority of the Company s annual net revenue and substantially all of its annual operating income.

Fiscal Year

The Company s fiscal year ends on the Saturday closest to December 31. The three-month periods ended September 29, 2007 and September 30, 2006, respectively, both consisted of 13 weeks. The nine-month periods ended September 29, 2007 and September 30, 2006, respectively, each consisted of 39 weeks.

Recent Accounting Pronouncements

In February 2007, Financial Accounting Standards Board (FASB) issued Statements of Financial Accounting Standards (SFAS) 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (SFAS 159). This statement expands the standards under SFAS 157, *Fair Value Measurement (SFAS 157)* ,to provide entities the one-time election (Fair Value Option or FVO) to measure financial instruments and certain other items at fair value. SFAS 159 also amends SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities,* to require the presentation of investments in available-for-sale securities and trading securities:

(a) in the aggregate of those fair value and non-fair-value amounts in the same line item and parenthetically disclose the amount of fair value included in the aggregate amount or;

(b) in two separate line items to display the fair value and non-fair-value carrying amounts.

FAS 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007. At the effective date, an entity may elect the fair value option for eligible items that exist at that date. The effect of the re-measurement is reported as a cumulative-effect adjustment to opening retained earnings. The Company is currently evaluating the effect that the adoption of SFAS 159 will have on its financial position and results of operations.

In September 2006, the FASB issued SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value under GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the effect that the adoption of SFAS 157 will have on its financial position and results of operations.

In June 2006, the FASB issued FASB Interpretation (FIN) 48, *Accounting for Uncertainty in Income Taxes* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with SFAS 109, *Accounting for Income Taxes*, (SFAS 109). FIN 48 defines the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements and seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. The Company is subject to the provisions of FIN 48 as of January 1, 2007. The Company believes that its income tax filing positions and deductions will be sustained on audit and does not anticipate any adjustments that will result in a material change to its financial position. Therefore, no material reserves for uncertain income tax positions have been recorded pursuant to FIN 48. In addition, the Company did not record a cumulative effect adjustment related to the adoption of FIN 48.

2. Intangible Assets

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

	September 29, 2007	December 30, 2006
Customer database gross carrying amount	$ 3,399,205	$ 3,399,205
Customer database accumulated amortization	(1,888,447)	(1,605,180)
Customer database net carrying amount	$ 1,510,758	$ 1,794,025

Amortization expense related to finite-lived intangible assets was approximately $0.1 million and $0.3 million for each of the three- and nine-month periods ended September 29, 2007 and September 30, 2006, respectively, and is recorded in selling, general and administration expenses on the consolidated statements of operations.

3. Debt

First Amendment to the Amended and Restated Credit Agreement

On September 26, 2007, the existing Amended and Restated Credit Agreement of the Company, as guarantor, and its subsidiaries (the Amended and Restated Credit Agreement), was amended by entering into the First Amendment to the Amended and Restated Credit Agreement by and among Golfsmith International, L.P., Golfsmith NU, L.L.C., and Golfsmith USA, L.L.C., as borrowers (the Borrowers), the Company and the subsidiaries of the Company identified therein as credit parties (the Credit Parties), General Electric Capital Corporation (the Lender), as Administrative Agent, Swing Line Lender and Letter of Credit Issuer, GE Capital Markets, Inc., as Sole Lead Arranger and Bookrunner, and the financial institutions from time to time parties thereto (the First Amendment together with the Amended and Restated Credit Agreement constitute the (Credit Facility). The Credit Facility consists of a $90.0 million asset-based revolving credit facility (the Revolver), including a $5.0 million letter of credit subfacility and a $10.0 million swing line subfacility. On an ongoing basis, certain loans incurred under the Credit Facility will be used for the working capital and general corporate purposes of the Borrowers and their subsidiaries (the Loans).

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Loans incurred under the Credit Facility bear interest in accordance with a graduated pricing matrix based on the average excess availability under the Revolver for the previous quarter. Borrowings under the Credit Facility are jointly and severally guaranteed by the Credit Parties, and are secured by a security interest granted in favor of the Administrative Agent, for itself and for the benefit of the lenders, in all of the personal and owned real property of the Credit Parties, including a lien on all of the equity securities of the Borrowers and each of Borrower s subsidiaries. The Credit Facility expires on June 16, 2011.

The Credit Facility contains customary affirmative covenants regarding, among other things, the delivery of financial and other information to the lenders, maintenance of records, compliance with law, maintenance of property and insurance and conduct of business. The Credit Facility also contains certain customary negative covenants that limit the ability of the Credit Parties to, among other things, create liens, make investments, enter into transactions with affiliates, incur debt, acquire or dispose of assets, including merging with another entity, enter into sale-leaseback transactions and make certain restricted payments. The foregoing restrictions are subject to certain customary exceptions for facilities of this type. The Credit Facility includes events of default (and related remedies, including acceleration of the loans made thereunder) usual for a facility of this type, including payment default, covenant default (including breaches of the covenants described above), cross-default to other indebtedness, material inaccuracy of representations and warranties, bankruptcy and involuntary proceedings, change of control, and judgment default. Many of the defaults are subject to certain materiality thresholds and grace periods usual for a facility of this type.

Available amounts under the Credit Facility are based on a borrowing base. The borrowing base is limited to (i) 85% of the net amount of eligible receivables, as defined in the Credit Facility, plus (ii) the lesser of (x) 70% of the value of eligible inventory or (y) up to 90% of the net orderly liquidation value of eligible inventory, plus (iii) the lesser of (x) $17,500,000 or (y) 70% of the fair market value of eligible real estate, and minus (iv) $3.5 million, which is an availability block used to calculate the borrowing base. The availability block may be increased to $5.0 million in the event the Lender chooses to syndicate the loan. At September 29, 2007, the Company had $42.5 million outstanding under the Credit Facility leaving $44.0 million in borrowing availability. At December 30, 2006, the Company had $41.5 million outstanding under the Credit Facility (as described below in this Note 3) leaving $21.0 million in borrowing availability.

Amended and Restated Credit Agreement

Pursuant to the Amended and Restated Credit Agreement, the Company had an asset-based revolving credit facility with $65.0 million availability, subject to an availability block of $2.5 million. Borrowings under the Amended and Restated Credit Agreement were secured by substantially all of Golfsmith s assets, excluding real property, equipment and proceeds thereof owned by Golfsmith, the Company, or Golfsmith s subsidiaries, and all of Golfsmith s stock and equivalent equity interest in any subsidiaries. Available amounts under the Amended and Restated Credit Agreement were based on a borrowing base. The borrowing base was limited to (i) 85% of the net amount of eligible receivables, as defined in the Amended and Restated Credit Agreement, plus (ii) the lesser of (x) 70% of the value of eligible inventory or (y) up to 90% of the net orderly liquidation value of eligible inventory, plus (iii) the lesser of (x) $17,500,000 or (y) 70% of the fair market value of eligible real estate, and minus (iv) $2.5 million, which was an availability block used to calculate the borrowing base.

4. Long-Lived Assets

The Company accounts for the impairment or disposal of long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment of Long-Lived Asset*s (SFAS 144), 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. There were no impairment losses for the three- and nine-month periods ended September 29, 2007 or September 30, 2006, respectively.

5. Accrued Expenses and Other Current Liabilities

The Company s accrued expenses and other current liabilities are comprised of the following at September 29, 2007 and December 30, 2006, respectively:

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	September 29, 2007	December 30, 2006
Gift cards and returns credits	$ 6,389,942	$ 8,455,340
Taxes	4,745,875	4,563,426
Salaries and benefits	2,012,343	1,707,951
Allowance for returns reserve	941,564	872,511
Interest	595,317	323,012
Other	1,549,728	1,609,070
Total	$ 16,234,769	$ 17,531,310

6. Comprehensive Income

The Company s comprehensive income is composed of net income and translation adjustments. There were no material differences between net income and comprehensive income during the three- and nine-month periods ended September 29, 2007 or September 30, 2006, respectively.

7. Earnings Per Share

Basic earnings per share is computed based on the weighted average number of common shares outstanding, including outstanding restricted stock awards. Diluted earnings per share is computed based on the weighted average number of common shares outstanding adjusted by the number of additional shares that would have been outstanding had the potentially dilutive common shares been issued. Potentially dilutive shares of common stock include outstanding stock options.

The following table sets forth the computation of basic and diluted net income (loss) per share:

	For the three months ended		For the nine months ended	
	September 29, 2007	September 30, 2006	September 29, 2007	September 30, 2006
Net income (loss)	$ 3,968,970	$ 3,369,103	$ 5,875,366	$ (5,444,109)
Basic:				
Weighted-average shares of common stock outstanding	15,771,187	15,691,898	15,757,898	11,931,679
Weighted-average shares of restricted common stock units outstanding		24,693		212,088
Weighted-average shares of deferred common stock units outstanding	42,277		26,378	
Shares used in computing basic net income (loss) per share	15,813,464	15,716,591	15,784,276	12,143,767
Effect of dilutive securities:				
Stock options and awards	31,142	140,381	169,709	
Shares used in computing diluted net income (loss) per share	15,844,606	15,856,972	15,953,985	12,143,767
Basic net income (loss) per share	$ 0.25	$ 0.21	$ 0.37	$ (0.45)

Diluted net income (loss) per share	$ 0.25	$ 0.21	$ 0.37	$ (0.45)

8. Stock-Based Compensation

On August 20, 2007, the Company granted 430,749 options to purchase common stock under the 2006 Incentive Compensation Plan. The Company calculates the fair value of stock compensation transactions using the Black-Scholes option-pricing model. This model incorporates various subjective assumptions including expected volatility, expected term and interest rates.

For the stock option grant on August 20, 2007, the calculation of expected volatility was based on a combination of the Company s historical volatility and the historical volatility for a comparable industry peer group over periods of time equivalent to the expected life of the awards granted. As the Company s history of trading in the public equity markets is relatively recent following its IPO, the Company believes this basis for expected volatility provides a more reasonable measurement of volatility in the calculation of the fair value of the options awarded. The expected term is calculated based on the average of the expected life of the stock option awarded. The Company bases the estimate of risk-free rate on the U.S. Treasury yield curve in effect at the time of grant or modification. The Company has never paid cash dividends and does not currently intend to pay cash dividends, and thus has assumed a 0% dividend yield. The fair value of stock option awards granted made in the three- and nine-month periods ended September 29, 2007 was estimated using the Black-Scholes option-pricing model with the following weighted-average assumptions:

Volatility	41%
Expected term (years)	6.5
Risk-fee interest rate	4%
Expected dividend yield	
Weighted average grant date fair value	$3.06

For the three-month periods ended September 29, 2007 and September 30, 2006, the Company recorded stock compensation expense of $0.1 million and $0.5 million, respectively, in selling, general and administrative expenses. For the nine-month periods ended September 29, 2007 and September 30, 2006, the Company recorded stock compensation expense of $0.5 million in selling, general and administrative expenses.

As of September 29, 2007, there was $1.9 million of unamortized stock compensation expense which is expected to be amortized over a weighted-average period of approximately 2.7 years. During the nine months ended September 29, 2007, 48,510 options were exercised with an intrinsic value of $0.1 million. During the nine months ended September 30, 2006, 6,100 options were exercised with a minimal intrinsic value.

9. Guarantees

The Company and its subsidiaries fully and unconditionally guarantee, and all of its future domestic subsidiaries will guarantee, the Credit Facility. At September 29, 2007, and December 30, 2006, there was $42.5 and $41.5 million, respectively, in borrowings outstanding under the Credit Facility and the Amended and Restated Credit Agreement, respectively.

The Company has no operations nor any assets or liabilities other than its investment in its wholly-owned subsidiary Golfsmith. Domestic subsidiaries of Golfsmith comprise all of Golfsmith s assets, liabilities and operations. There are no restrictions on the transfer of funds between the Company, Golfsmith and any of Golfsmith s domestic subsidiaries.

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, historically such costs have not been material. During the three- and nine-month periods ended September 29, 2007 and September 30, 2006, respectively, no material amounts have been accrued or paid relating to product warranties.

10. Commitments and Contingencies

Lease Commitments

The Company leases certain store locations under operating leases that provide for annual payments that, in some cases, increase over the life of the lease. The aggregate of the minimum annual payments is expensed on a straight-line basis over the term of the related lease without consideration of renewal option periods. The lease agreements contain provisions that require the Company to pay for normal repairs and maintenance, property taxes and insurance.

Future minimum payments due under non-cancelable operating leases with initial terms of one year or more are as follows for each of the 12 months periods ending at the end of our second fiscal quarter for each of the years presented below:

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	Operating Lease Obligations	Sublease Income
2008	$ 23,020,133	$ 1,502,723
2009	22,043,432	1,294,758
2010	21,578,709	949,626
2011	21,665,376	807,719
2012	21,250,077	791,124
Thereafter	63,597,190	1,836,175
Total minimum lease payments	$ 173,154,917	$ 7,182,125

State Income Taxes

In December 2006, the Company recorded an increase to goodwill and accrued expenses of approximately $0.9 million relating to state taxes generated during periods prior to the acquisition in 2002 by Golfsmith International Holdings, Inc. of Golfsmith International, Inc. (the State Taxes Owed). The Company continues to believe that the State Taxes Owed are liabilities of the individuals who were shareholders of Golfsmith International, Inc. (Selling Shareholders) prior to the acquisition in 2002, which are payable directly by the Selling Shareholders and/or are reimbursable to the Company by the Selling Shareholders. The Selling Shareholders have not yet acknowledged their liabilities for State Taxes Owed. If the Company s position is correct, the amounts would be reversed upon a final determination that the State Taxes Owed are liabilities of the Selling Shareholders.

Additionally, we estimate that, as of September 29, 2007, there could be $0.6 million in accrued penalties and interest related to the State Taxes Owed, although such penalties and interest have not been assessed by any taxing authority at this time. We believe that any related penalties and interest are also liabilities of the Selling Shareholders. If any such penalties and interest are subsequently determined not to be liabilities of the Selling Shareholders, which are payable by them and/or are reimbursable to the Company by them, and are liabilities of the Company or its subsidiaries, such penalties and interest could result in charges to income in the period of that determination.

Legal Proceedings

The Company is involved in various legal proceedings arising in the ordinary course of conducting business. The Company believes that the ultimate outcome of such matters, in the aggregate, will not have a material adverse impact on its financial position, liquidity or results of operations.

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and related notes included elsewhere in this report.

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, intend, or similar 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 not guarantees of performance. These statements are based on our management s beliefs and assumptions, which in turn are based in part on currently available information and in part on management s estimates and projections of future events and conditions. 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 Risk Factors set forth in Item 1A. Risk Factors in our Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 30, 2007.

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.

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