GNC CORP
Form 10-Q
November 04, 2005

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington D.C. 20549
Form 10-Q

(Mark one)

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

For the quarterly period ended September 30, 2005

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: 333-116040

GNC CORPORATION

(Exact name of registrant as specified in its charter)

DELAWARE	***72-1575170***
(State or other jurisdiction of Incorporation or organization)	(I.R.S. Employer Identification No.)
300 Sixth Avenue **Pittsburgh, Pennsylvania**	**15222**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: **(412) 288-4600**

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. þ Yes o No

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

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

As of September 30, 2005, 29,555,288 shares of the registrant s $0.01 par value Common Stock (the Common Stock) were outstanding.

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PART I FINANCIAL INFORMATION
Item 1. Financial Statements

GNC CORPORATION AND SUBSIDIARIES
Consolidated Balance Sheets
(in thousands, except share data)

	September 30, 2005 (unaudited)	December 31, 2004 *
Current assets:		
Cash and cash equivalents	$ 62,403	$ 85,161
Receivables, net of reserve of $7,942 and $7,214, respectively	71,344	68,148
Inventories, net (Note 3)	280,835	272,254
Deferred tax assets, net	10,825	14,133
Other current assets	32,664	36,382
Total current assets	458,071	476,078
Long-term assets:		
Goodwill (Note 4)	79,439	78,585
Brands (Note 4)	212,000	212,000
Other intangible assets, net (Note 4)	26,505	28,652
Property, plant and equipment, net	181,684	195,409
Deferred financing fees, net	16,809	18,130
Deferred tax assets, net		1,093
Other long-term assets	11,735	21,393
Total long-term assets	528,172	555,262
Total assets	$ 986,243	$ 1,031,340
Current liabilities:		
Accounts payable, includes cash overdraft of $3,076 and $4,144, respectively	$ 82,380	$ 106,557
Accrued payroll and related liabilities	15,978	20,353
Accrued interest (Note 5)	9,164	1,863
Current portion, long-term debt (Note 5)	2,043	3,901
Other current liabilities	58,732	61,325
Total current liabilities	168,297	193,999
Long-term liabilities:		
Long-term debt (Note 5)	471,834	506,474
Deferred tax liabilities, net	1,965	
Other long-term liabilities	10,687	9,866
Total long-term liabilities	484,486	516,340

Total liabilities		652,783		710,339
Cumulative redeemable exchangeable preferred stock, $0.01 par value, 110,000 shares authorized, 100,000 shares issued and outstanding (liquidation preference of $134,342 and $123,815, respectively)		123,360		112,734
Stockholders equity:				
Common stock, 0.01 par value, 100,000,000 shares authorized, 29,555,288 and 29,854,663 shares issued and outstanding, respectively		296		299
Paid-in-capital		177,050		178,245
Retained earnings		31,320		28,924
Treasury stock, at cost, 0 and 100,000 shares, respectively				(364)
Accumulated other comprehensive income		1,434		1,163
Total stockholders equity		210,100		208,267
Total liabilities and stockholders equity	$	986,243	$	1,031,340

* Footnotes summarized from the Audited Financial Statements

The accompanying notes are an integral part of the consolidated financial statements.

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GNC CORPORATION AND SUBSIDIARIES
Consolidated Statements of Operations and Comprehensive Income
(unaudited)
(in thousands)

	For the three months ended September 30,		For the nine months ended September 30,	
	2005	**2004**	**2005**	**2004**
Revenue	$ 322,559	$ 323,141	$ 992,341	$ 1,043,424
Cost of sales, including costs of warehousing, distribution and occupancy	222,084	216,818	676,264	690,541
Gross profit	100,475	106,323	316,077	352,883
Compensation and related benefits	58,432	54,034	171,975	172,959
Advertising and promotion	8,639	10,042	36,780	35,252
Other selling, general and administrative	18,536	19,171	56,265	55,831
Foreign currency (gain) loss	(80)	(300)	(137)	118
Other expense (income)		1,330	(2,500)	1,330
Operating income	14,948	22,046	53,694	87,393
Interest expense, net (Note 5)	9,957	8,570	33,233	25,786
Income before income taxes	4,991	13,476	20,461	61,607
Income tax expense	1,816	4,977	7,439	22,513
Net income	3,175	8,499	13,022	39,094
Other comprehensive income	805	747	271	292
Comprehensive income	$ 3,980	$ 9,246	$ 13,293	$ 39,386

The accompanying notes are an integral part of the consolidated financial statements

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GNC CORPORATION AND SUBSIDIARIES
Consolidated Statements of Stockholders Equity
(in thousands, except share data)

	Common Stock Shares	Common Stock Dollars	Paid-in-Capital	Retained Earnings	Treasury Stock Shares	Treasury Stock Dollars	Accumulated Other Comprehensive Income	Total Stockholders Equity
Balance at December 31, 2004	**29,854,663**	**$ 299**	**$ 178,245**	**$ 28,924**	**(100,000)**	**$ (364)**	**$ 1,163**	**$ 208,267**
Retirement of treasury stock	(100,000)	(1)	(363)		100,000	364		
Repurchase and retirement of common stock	(199,375)	(2)	(832)					(834)
Preferred stock dividends				(10,527)				(10,527)
Amortization of preferred stock issuance costs				(99)				(99)
Net income				13,022				13,022
Foreign currency translation adjustments							271	271
Balance at September 30, 2005 (unaudited)	**29,555,288**	**$ 296**	**$ 177,050**	**$ 31,320**		**$**	**$ 1,434**	**$ 210,100**

The accompanying notes are an integral part of the consolidated financial statements.

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GNC CORPORATION AND SUBSIDIARIES
Consolidated Statements of Cash Flows
(unaudited)
(in thousands)

	For the nine months ended September 30, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 13,022	$ 39,094
Depreciation expense	27,840	24,976
Fixed asset write-off	366	
Deferred fee writedown early debt extinguishment	3,890	
Amortization of intangible assets	2,985	3,011
Amortization of deferred financing fees	2,103	2,058
Increase in provision for inventory losses	5,889	8,470
Increase in provision for losses on accounts receivable	1,894	1,942
Decrease in net deferred taxes	6,368	21,682
Changes in assets and liabilities:		
Increase in receivables	(7,665)	(3,657)
Increase in inventory, net	(13,431)	(7,651)
Decrease in franchise note receivables, net	7,568	8,520
Decrease in other assets	5,805	5,406
Decrease in accounts payable	(23,128)	(19,023)
Decrease in accrued taxes		(438)
Increase in interest payable	7,301	4,674
Decrease in accrued liabilities	(6,153)	(28,532)
Net cash provided by operating activities	34,654	60,532
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures	(13,819)	(17,865)
Sale of corporate stores to franchisees	23	168
Store acquisition costs	(547)	(522)
Acquisition of General Nutrition Companies, Inc		2,102
Net cash used in investing activities	(14,343)	(16,117)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of common stock		1,581
Repurchase and retirement of common stock	(834)	
Decrease in cash overdrafts	(1,067)	(3,813)
Payments on long-term debt	(186,500)	(2,866)
Proceeds from senior notes issuance	150,000	
Financing fees	(4,672)	(327)
Net cash used in financing activities	(43,073)	(5,425)

Effect of exchange rate on cash	4	218
Net (decrease) increase in cash	(22,758)	39,208
Beginning balance, cash	85,161	33,176
Ending balance, cash	$ 62,403	$ 72,384

The accompanying notes are an integral part of the consolidated financial statements.

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GNC CORPORATION AND SUBSIDIARIES
SUMMARIZED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1. NATURE OF BUSINESS

General Nature of Business. GNC Corporation (the Company), formerly known as General Nutrition Centers Holding Company, a Delaware corporation, is a leading specialty retailer of vitamin, mineral and herbal supplements, diet and sports nutrition products and other wellness products. The Company is also a provider of personal care and other health related products. The Company operates primarily in three business segments: Retail, Franchising and Manufacturing/Wholesale. The Company manufactures the majority of its branded products, and also merchandises various third-party products. Additionally, the Company licenses the use of its trademarks and trade names. The processing, formulation, packaging, labeling and advertising of the Company s products are subject to regulation by one or more federal agencies, including the Food and Drug Administration, Federal Trade Commission, Consumer Product Safety Commission, United States Department of Agriculture and the Environmental Protection Agency. These activities are also regulated by various agencies of the states and localities in which the Company s products are sold.

Acquisition of the Company. On October 16, 2003, the Company entered into a purchase agreement (the Purchase Agreement) with Koninklijke (Royal) Numico N.V. (Numico) and Numico USA, Inc. to acquire 100% of the outstanding equity interest of General Nutrition Companies, Inc. (GNCI) from Numico USA, Inc. on December 5, 2003 (the Acquisition). The purchase equity contribution was made by GNC Investors, LLC (GNC LLC), an affiliate of Apollo Management L.P. (Apollo), together with additional institutional investors and certain management of the Company. The equity contribution from GNC LLC was recorded by the Company. The Company utilized this equity contribution to purchase the investment in General Nutrition Centers, Inc., (Centers). Centers is a wholly owned subsidiary of the Company.

NOTE 2. BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by the Company in accordance with accounting principles generally accepted in the United States of America for interim financial reporting and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and related footnotes that would normally be required by accounting principles generally accepted in the United States of America for complete financial reporting. These unaudited consolidated financial statements should be read in conjunction with the Company s audited consolidated financial statements in the Company s Annual Report on Form 10-K filed for the year ended December 31, 2004 (the Form 10-K).

The accompanying unaudited consolidated financial statements include all adjustments (consisting of a normal and recurring nature) that management considers necessary for a fair statement of financial information for the interim periods. Interim results are not necessarily indicative of the results that may be expected for the remainder of the year ending December 31, 2005.

Use of Estimates. 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. Accordingly, these estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Some of the most significant estimates pertaining to the Company include the valuation of inventories, the allowance for doubtful accounts, income tax valuation allowances and the recoverability of long-lived assets. On a continual basis, management reviews its estimates utilizing currently available information, changes in facts and circumstances, historical experience and reasonable assumptions. After such reviews, and if deemed appropriate, those estimates are adjusted accordingly. Actual results could differ from those estimates. There have been no material changes to critical estimates since the audited financial statements at December 31, 2004, except as noted in the accounts receivable discussion below.

Cash and Cash Equivalents. The Company considers cash and cash equivalents to include all cash and liquid deposits and investments with a maturity of three months or less. The majority of payments due from banks for third-party credit cards process within 24-48 hours, except for transactions occurring on a Friday, which are generally processed the following Monday. All credit card transactions are classified as cash and the amounts due from these transactions totaled $1.6 million at September 30, 2005 and $1.4 million at December 31, 2004.

Accounts Receivable and Allowance for Doubtful Accounts. The Company sells product to its franchisees and, to a lesser extent, various third parties. To determine the allowance for doubtful accounts, the Company evaluates factors that affect collectibility from the Company s franchisees or customers including but not limited to their financial strength, payment history, reported sales and the overall retail economy. The Company establishes an allowance for doubtful accounts for franchisees based on an assessment of the franchisees operations which includes analysis of their current year to date operating cash flows, retail sales levels, and status of amounts due to the Company, such as rent, interest and advertising. As a result of the increase in franchise store acquisitions in 2005, the Company updated its estimated net reserve balance. The Company calculates the total estimated uncollectible receivables amount for each franchisee and deducts the estimated value of tangible property held by the franchisees that the Company can acquire in lieu of cash payments if the Company elects to convert the store. An allowance for international franchisees is calculated based on unpaid, unsecured amounts associated with their receivable balance. An allowance for receivable balances due from third parties is recorded, if considered necessary, based on facts and circumstances. These allowances are deducted from the related receivables and reflected net in the accompanying financial statements.

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GNC CORPORATION AND SUBSIDIARIES
SUMMARIZED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED CONTINUED)

Stock Compensation. In accordance with Accounting Principles Board (APB) No. 25, Accounting for Stock issued to Employees , the Company accounts for stock-based employee compensation using the intrinsic value method of accounting. For the three and nine months ended September 30, 2005 and 2004, stock compensation represents shares of the Company s stock issued pursuant to the General Nutrition Centers Holding Company (presently known as GNC Corporation) 2003 Omnibus Stock Incentive Plan. The common stock associated with this plan is not registered or traded on any exchange. Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-based Compensation , prescribes that companies utilize the fair value method of valuing stock-based compensation and recognize compensation expense accordingly. SFAS No. 123 did not require that the fair value method be adopted and reflected in the financial statements. However, in December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123(R) which sets accounting requirements for share-based compensation. It requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation and disallows the use of the intrinsic value method of accounting for stock compensation. This statement is not effective for the Company until the beginning of its fiscal year 2006 and will be adopted prospectively. The Company has adopted the disclosure requirements of SFAS No. 148 Accounting for Stock Based Compensation-Transition and Disclosure-an amendment of SFAS No. 123 by illustrating compensation costs in the following table and will adopt SFAS No. 123(R) beginning January 1, 2006.

Had compensation costs for stock options been determined using the fair market value method of SFAS No. 123, the effect on net income for each of the periods presented would have been as follows:

	Three Months ended September 30,		Nine Months ended September 30,	
	2005	2004	2005	2004
	(unaudited) (in thousands)			
Net income as reported	$ 3,175	$ 8,499	$ 13,022	$ 39,094
Less: total stock-based employee compensation costs determined using fair value method, net of related tax effects	(187)	(217)	(582)	(649)
Adjusted net income	$ 2,988	$ 8,282	$ 12,440	$ 38,445

Recently Issued Accounting Pronouncements

In May 2005, the FASB issued SFAS No. 154, Accounting Changes and Error Correction a replacement of APB Opinion No. 20 and FASB Statement No. 3. This Statement replaces APB Opinion No. 20, Accounting Changes, and FASB Statement No. 3, Reporting Accounting Changes in Interim Financial Statements, and changes the requirements for the accounting and reporting of a change in accounting principle. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. This statement defines retrospective application as the application of a different accounting principle to prior accounting periods as if that principle had always been used or as the adjustment of previously issued financial statements to reflect a change in the reporting entity. This statement also redefines restatement as the revising of previously issued financial statements to reflect the correction of an error. This statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company will adopt this standard beginning the first quarter of fiscal year 2006.

In December 2004, the FASB issued SFAS No. 123 (Revised 2004) Share-Based Payment: an Amendment of FASB Statements No. 123 and 95 . SFAS No. 123(R) defines accounting requirements for share-based compensation to employees. It requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees and disallows the use of the intrinsic value method of accounting for stock compensation. Originally SFAS No. 123(R) was applicable for all interim and fiscal periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission (SEC) announced that it was extending the adoption of SFAS No. 123(R) for public companies to be applicable for all fiscal periods beginning after June 15, 2005. As the Company is not a public entity as defined by SFAS No. 123(R), this statement is not effective for the Company until the beginning of its fiscal year 2006. The Company will adopt this statement prospectively. As the Company is continuing to evaluate the adoption of SFAS No. 123(R), the Company does not expect this statement to have a significant impact on the Company s consolidated financial statements or results of operations.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29, Accounting for Nonmonetary Transactions . The amendments made by SFAS No. 153 are based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the narrow exception for nonmonetary exchanges of similar productive assets and replace it with a broader exception for exchanges of nonmonetary assets that do not have commercial substance. The statement is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. Earlier application is permitted for nonmonetary asset exchanges occurring in fiscal periods beginning after the date of issuance. The provisions of this statement will be applied prospectively. The Company does not anticipate the adoption of SFAS No. 153 to have a significant impact on the Company s consolidated financial statements or results of operations.

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GNC CORPORATION AND SUBSIDIARIES

SUMMARIZED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED CONTINUED)

In November 2004, the FASB issued SFAS No. 151, Inventory Costs , an amendment of Accounting Research Bulletin (ARB) No. 43, to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage). This statement requires that those items be recognized as current-period charges regardless of whether they meet the criterion of so abnormal . In addition, this statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. Companies are required to adopt the provisions of this statement for fiscal years beginning after June 15, 2005. The Company will adopt this standard beginning the first quarter of fiscal year 2006 and currently is evaluating the effects of this statement on its consolidated financial statements.

NOTE 3. INVENTORIES, NET

Inventories at each respective period consisted of the following:

	September 30, 2005		
	Gross cost	Reserves	Net Carrying Value
		(unaudited) (in thousands)	
Finished product ready for sale	$ 241,104	$ (9,067)	$ 232,037
Unpackaged bulk product and raw materials	47,724	(3,036)	44,688
Packaging supplies	4,110		4,110
	$ 292,938	$ (12,103)	$ 280,835

	December 31, 2004		
	Gross cost	Reserves	Net Carrying Value
		(in thousands)	
Finished product ready for sale	$ 242,578	$ (11,542)	$ 231,036
Unpackaged bulk product and raw materials	41,607	(	