

DSW Inc.
Form 10-Q
September 05, 2008

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

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

For the quarterly period ended August 2, 2008

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 1-32545
DSW INC.**

(Exact name of registrant as specified in its charter)

Ohio

31-0746639

(State or other jurisdiction of
Incorporation or organization)

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

810 DSW Drive, Columbus, Ohio

43219

(Address of principal executive offices)

(Zip Code)

(614) 237-7100

Registrant's telephone number, including area code
N/A

(Former name, former address and former fiscal year, if changed since last report)

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 a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input type="checkbox"/>	Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>
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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). ☐ Yes ☐ No
The number of outstanding Class A Common Shares, without par value, as of August 31, 2008 was 16,307,179 and Class B Common Shares, without par value, as of August 31, 2008 was 27,702,667.

DSW INC.
TABLE OF CONTENTS

Item No.	Page
Part I. Financial Information	
Item 1. Financial Statements	
Condensed Consolidated Balance Sheets at August 2, 2008 and February 2, 2008	2
Condensed Consolidated Statements of Income for the three and six months ended August 2, 2008 and August 4, 2007	3
Condensed Consolidated Statements of Shareholders' Equity for the six months ended August 2, 2008 and August 4, 2007	4
Condensed Consolidated Statements of Cash Flows for the six months ended August 2, 2008 and August 4, 2007	5
Notes to the Condensed Consolidated Financial Statements	6
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	12
Item 3. Quantitative and Qualitative Disclosures About Market Risk	20
Item 4. Controls and Procedures	20
Part II. Other Information	
Item 1. Legal Proceedings	21
Item 1A. Risk Factors	21
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	21
Item 3. Defaults Upon Senior Securities	22
Item 4. Submission of Matters to a Vote of Security Holders	22
Item 5. Other Information	22
Item 6. Exhibits	22
Signature	23
Index to Exhibits	24

Part I. FINANCIAL INFORMATION**Item 1. Financial Statements**

DSW INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except share amounts)
(unaudited)

	August 2, 2008	February 2, 2008
ASSETS		
Cash and equivalents	\$ 57,687	\$ 61,801
Short-term investments	75,480	70,005
Accounts receivable, net	6,190	11,805
Accounts receivable from related parties, net	5,691	2,538
Inventories	286,869	262,037
Prepaid expenses and other current assets	24,850	23,134
Deferred income taxes	21,903	20,302
Total current assets	478,670	451,622
Property and equipment, net	220,554	192,772
Long-term investments	5,760	12,500
Goodwill	25,899	25,899
Tradenames and other intangibles, net	4,095	4,522
Deferred income taxes and other assets	3,646	6,567
Total assets	\$738,624	\$693,882
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accounts payable	\$124,351	\$113,605
Accounts payable to related parties	841	990
Accrued expenses:		
Taxes	12,274	9,881
Customer loyalty program	6,780	6,410
Gift cards and merchandise credits	12,897	14,231
Other	28,616	23,788
Total current liabilities	185,759	168,905
Deferred income taxes and other non-current liabilities	95,782	91,497
Commitments and contingencies		
Shareholders' equity:		
	290,898	288,365

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Class A Common Shares, no par value; 170,000,000 authorized; 16,307,179 and 16,263,569 issued and outstanding, respectively

Class B Common Shares, no par value; 100,000,000 authorized; 27,702,667 and 27,702,667 issued and outstanding, respectively

Preferred Shares, no par value; 100,000,000 authorized; no shares issued or outstanding

Retained earnings	166,360	145,115
Accumulated other comprehensive loss	(175)	
Total shareholders' equity	457,083	433,480
Total liabilities and shareholders' equity	\$738,624	\$693,882

DSW INC.
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share amounts)
(unaudited)

	Three months ended		Six months ended	
	August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
Net sales	\$ 357,175	\$ 348,718	\$ 723,439	\$ 705,715
Cost of sales	(256,081)	(267,368)	(525,298)	(515,109)
Gross profit	101,094	81,350	198,141	190,606
Operating expenses	(83,415)	(73,024)	(164,456)	(145,062)
Operating profit	17,679	8,326	33,685	45,544
Interest expense	(304)	(143)	(578)	(281)
Interest income	724	2,091	1,721	3,948
Interest income, net	420	1,948	1,143	3,667
Earnings before income taxes	18,099	10,274	34,828	49,211
Income tax provision	(7,142)	(3,753)	(13,583)	(18,946)
Net income	\$ 10,957	\$ 6,521	\$ 21,245	\$ 30,265
Basic and diluted earnings per share:				
Basic	\$ 0.25	\$ 0.15	\$ 0.48	\$ 0.69
Diluted	\$ 0.25	\$ 0.15	\$ 0.48	\$ 0.68
Shares used in per share calculations:				
Basic	43,999	43,953	43,983	43,947
Diluted	44,242	44,338	44,195	44,349

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

DSW INC.
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
(in thousands)
(unaudited)

	Number of		Class		Accumulated		
	Class A	Class B	Class A	Class B	Retained	Other	Total
	Common	Common	Common	Common	Earnings	Comprehensive	
	Shares	Shares	Shares	Shares		Loss	
Balance, February 3, 2007	16,239	27,703	\$283,108	\$ 0	\$ 91,471	\$ 0	\$374,579
Net income					30,265		30,265
Cumulative effect of FIN 48 adoption					(131)		(131)
Stock units granted	7		278				278
Exercise of stock options	8		59				59
Excess tax benefit related to stock option exercises			88				88
Stock based compensation expense, before related tax effects			2,001				2,001
Balance, August 4, 2007	16,254	27,703	\$285,534	\$ 0	\$121,605	\$ 0	\$407,139
Balance, February 2, 2008	16,264	27,703	\$288,365	\$ 0	\$145,115	\$ 0	\$433,480
Net income					21,245		21,245
Unrealized loss on available-for-sale securities, net of tax benefit of \$115						(175)	(175)
<i>Total comprehensive income</i>							21,070
Stock units granted	41		557				557

Tax shortfall related to restricted stock unit exercises			(23)			(23)
Exercise of restricted stock units, net of settlement of taxes	2		(13)			(13)
Stock based compensation expense, before related tax effects			2,012			2,012

Balance, August 2, 2008	16,307	27,703	\$290,898	\$ 0	\$166,360	\$ (175)	\$457,083
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The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

DSW INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six months ended	
	August 2, 2008	August 4, 2007
Cash flows from operating activities:		
Net income	\$ 21,245	\$ 30,265
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,711	10,874
Amortization of debt issuance costs	59	59
Stock based compensation expense	2,012	2,001
Deferred income taxes	2,141	(1,612)
Loss on disposal of assets	125	77
Impairment charges	730	
Grants of stock units	557	278
Other noncurrent liabilities	(6,516)	(2,596)
Change in working capital, assets and liabilities:		
Accounts receivable, net	2,462	(4,184)
Inventories	(24,832)	(20,382)
Prepaid expenses and other assets	(1,993)	(6,451)
Accounts payable	13,162	37,172
Proceeds from construction and tenant allowances	10,416	7,219
Accrued expenses	2,239	(9,544)
Net cash provided by operating activities	37,518	43,176
Cash flows from investing activities:		
Cash paid for property and equipment	(42,611)	(37,339)
Purchases of available-for-sale investments	(107,639)	(23,200)
Purchases of held-to-maturity investments	(2,000)	
Maturities and sales from available-for-sale investments	110,618	18,875
Purchase of intangible asset		(21)
Net cash used in investing activities	(41,632)	(41,685)
Cash flows from financing activities:		
Proceeds from exercise of stock options		59
Excess tax benefit related to stock option exercises		88
Net cash provided by financing activities		147

Net (decrease) increase in cash and equivalents	(4,114)	1,638
Cash and equivalents, beginning of period	61,801	73,205
Cash and equivalents, end of period	\$ 57,687	\$ 74,843

Supplemental disclosures of cash flow information:

Cash paid during the period for income taxes	\$ 12,869	\$ 25,755
Noncash investing and operating activities		
Increase in accounts payable and accrued expenses from asset purchases	1,312	1,873

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements

DSW INC.
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. BUSINESS OPERATIONS

DSW Inc. (DSW) and its wholly-owned subsidiaries, including DSW Shoe Warehouse, Inc. (DSWSW), are herein referred to collectively as DSW or the Company . DSW 's Class A Common Shares are listed on the New York Stock Exchange trading under the ticker symbol DSW . At August 2, 2008, Retail Ventures, Inc. (RVI or Retail Ventures) owned approximately 63.0% of DSW 's outstanding Common Shares, representing approximately 93.2% of the combined voting power of DSW 's outstanding Common Shares. On January 23, 2008, Retail Ventures disposed of an 81% ownership interest in its Value City business to VCHI Acquisition Co., a newly formed entity owned by VCDS Acquisition Holdings, LLC, Emerald Capital Management LLC and Crystal Value, LLC.

As of August 2, 2008, DSW operated a total of 274 stores located throughout the United States and dsw.com. DSW stores offer a wide selection of better-branded dress, casual and athletic footwear for men and women, as well as accessories. During the six months ended August 2, 2008, DSW opened 16 new DSW stores, closed one DSW store and launched dsw.com. DSW also operates leased departments for three non-affiliated retailers and one affiliated retailer in its leased department segment. As of August 2, 2008, DSW supplied merchandise to 282 Stein Mart stores, 65 Gordmans stores, 36 Filene 's Basement stores, and one Frugal Fannie 's store. During the six months ended August 2, 2008, DSW added seven new non-affiliated leased departments and ceased operations in one non-affiliated leased department. DSW owns the merchandise, records sales of merchandise net of returns and sales tax, owns the fixtures (except for Filene 's Basement, the affiliated retailer) and provides supervisory assistance in these locations. Stein Mart, Gordmans, Filene 's Basement and Frugal Fannie 's provide the sales associates. DSW pays a percentage of net sales as rent.

2. BASIS OF PRESENTATION

The accompanying unaudited interim condensed consolidated financial statements should be read in conjunction with the Company 's Annual Report on Form 10-K as filed with the Securities and Exchange Commission (SEC) on April 17, 2008 (the 2007 Annual Report).

In the opinion of management, the unaudited interim condensed consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments, which are necessary to present fairly the consolidated financial position, results of operations and cash flows for the periods presented.

3. ADOPTION OF ACCOUNTING STANDARDS

In September 2006, the FASB issued FASB Statement No. 157, *Fair Value Measurements* (FAS 157), which defines fair value, establishes a framework for measuring fair value in GAAP, and expands disclosures about fair value measurements. The intent of this standard is to ensure consistency and comparability in fair value measurements and enhanced disclosures regarding the measurements. This statement is effective for financial assets and liabilities for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. For non-financial assets and liabilities measured at fair value on a non-recurring basis, FAS 157 is effective for fiscal years beginning after November 15, 2008. DSW is currently evaluating the impact of the adoption of FAS 157 for non-financial assets and liabilities on its financial position and results of operations.

Although the adoption of this standard for financial assets and liabilities in the quarter ended May 3, 2008 had no impact on DSW 's financial position or results of operations, it does result in additional disclosures regarding fair value measurements. It defines fair value as the price that would be received to sell an asset or paid to transfer a

liability in an orderly transaction between market participants at the measurement date. Therefore, fair value is a market-based measurement based on assumptions of the market participants. As a basis for these assumptions, FAS 157 establishes the following three level fair value hierarchy:

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that are publicly accessible. Active markets have frequent transactions with enough volume to provide ongoing pricing information.

Level 2 inputs are other than level 1 inputs that are directly or indirectly observable. These can include unadjusted quoted prices for similar assets or liabilities in active markets, unadjusted quoted prices for identical assets or liabilities in inactive market, or other observable inputs.

Level 3 inputs are unobservable inputs.

DSW INC.
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Financial assets and liabilities measured at fair value on a recurring basis as of August 2, 2008 consisted of the following:

	Balance at August 2, 2008	Level 1	Level 2	Level 3
		(in thousands)		
Assets:				
Cash and equivalents	\$ 57,687	\$ 6,421	\$ 51,266	
Short-term investments	75,480		75,430	\$ 50
Long-term investments	5,760			5,760
	\$ 138,927	\$ 6,421	\$ 126,696	\$ 5,810

Cash and equivalents primarily represent cash deposits and investments in money market funds held with financial institutions. The activity related to level 3 investments for the six months ended August 2, 2008 is summarized below:

	Short-term (in thousands)	Long-term
Carrying value as of February 2, 2008	\$ 70,005	\$ 12,500
Maturities and sales	(68,805)	(7,600)
Transfers between short-term and long-term investments	(1,150)	1,150
Unrealized losses included in accumulated other comprehensive loss		(290)
Carrying value as of August 2, 2008	\$ 50	\$ 5,760

In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (FAS 159). This statement allows entities to choose to measure financial instruments and certain other financial assets and financial liabilities at fair value. FAS 159 is effective for fiscal years beginning after November 15, 2007. The adoption of this standard in the quarter ended August 2, 2008 had no impact on DSW's financial position or results of operations. DSW has not currently elected the fair value provisions for any assets or liabilities, but DSW may elect to measure certain assets and liabilities using the fair value option in the future.

4. STOCK BASED COMPENSATION

DSW has a 2005 Equity Incentive Plan that provides for the issuance of equity awards to purchase up to 4,600,000 common shares, including stock options and restricted stock units to management, key employees of DSW and affiliates, consultants (as defined in the plan), and directors of DSW. During the three months ended August 2, 2008 and August 4, 2007, the Company recorded stock based compensation expense of approximately \$0.9 million and \$1.1 million, respectively, and for each of the six months ended August 2, 2008 and August 4, 2007, the Company recorded stock based compensation expense of approximately \$2.0 million.

The following table summarizes the Company's stock option and restricted stock unit activity for the six months ended August 2, 2008 (in thousands):

	Six Months Ended August 2, 2008	
	Stock Options	Restricted Stock Units
Outstanding, beginning of period	1,520	151
Granted	1,028	133
Exercised		(4)
Forfeited	(222)	(45)
Outstanding, end of period	2,326	235
Exercisable, end of period	613	

DSW INC.
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Stock Options

The weighted-average grant date fair value of each option granted in the three months ended August 2, 2008 and August 4, 2007 was \$6.10 and \$15.52 per share, respectively, and for the six months ended August 2, 2008 and August 4, 2007 was \$5.88 and \$17.66, respectively. The following table illustrates the weighted-average assumptions used in the Black-Scholes option-pricing model for options granted in each of the periods presented.

	Six Months Ended	
	August 2, 2008	August 4, 2007
Assumptions:		
Risk-free interest rate	2.73%	4.90%
Expected volatility of DSW common stock	48.07%	36.46%
Expected option term	4.9 years	5.0 years
Expected dividend yield	0.0%	0.0%
<i>Restricted Stock Units</i>		

The total aggregate intrinsic value of nonvested restricted stock units at August 2, 2008 was \$3.2 million. As of August 2, 2008, the total compensation cost related to nonvested restricted stock units not yet recognized was approximately \$2.5 million with a weighted average expense recognition period remaining of 2.4 years. The weighted average exercise price for all restricted stock units is zero.

Director Stock Units

DSW issues stock units to directors who are not employees of DSW or RVI. During the six months ended August 2, 2008 and August 4, 2007, DSW granted 41,229 and 7,426 director stock units, respectively, and expensed \$0.6 million and \$0.3 million in each respective six month period for these grants. As of August 2, 2008, 79,165 director stock units had been issued and no director stock units had been settled.

5. INVESTMENTS

The long-term investments balance at both August 2, 2008 and February 2, 2008 includes auction rate securities that failed at auction subsequent to February 2, 2008 and are presented as long-term as it is unknown if the Company will be able to liquidate these securities within one year. As a result, for the six months ended August 2, 2008, the Company recorded a temporary impairment of \$0.3 million, before taxes, related to its long-term investments. The auction rate securities are typically available for auction every 91 to 182 days. The maturity dates of the underlying auction rate securities are through 2034.

Short-term investments at August 2, 2008 include auction rate securities that settled at auction after the balance sheet date or securities that have been redeemed by the underlying issuer. The other short-term investments include variable rate demand notes, tax exempt bonds, tax advantaged bonds and tax exempt commercial paper. These other types of short-term investments, excluding tax exempt commercial paper, generally have interest reset dates of 7 to 126 days. Despite the long-term nature of the stated contractual maturities of the bonds, tax exempt commercial paper and variable rate demand notes, the Company has the ability to quickly liquidate these securities. As a result, other than one security classified as held to maturity that the Company has the ability and intent to hold

until maturity, the Company has classified these securities as available for sale. At February 2, 2008, the short-term investment balance included variable rate demand notes and auction rate securities.

DSW INC.
NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

The following table discloses the major categories of our investments as of August 2, 2008 and February 2, 2008:

	Short-term investments		Long-term investments	
	August 2, 2008	February 2, 2008	August 2, 2008	February 2, 2008
	(in thousands)			
Available for sale:				
Tax exempt bonds	\$ 36,991			
Tax advantaged bonds	2,000			
Variable rate demand notes	22,150	\$ 44,505		
Tax exempt commercial paper	12,285			
Auction rate securities	50	25,500	\$ 6,050	\$ 12,500
Unrealized losses included in accumulated other comprehensive loss			(290)	
Total available for sale	\$ 73,476	\$ 70,005	\$ 5,760	\$ 12,500
Held to maturity	2,004			
Total investments	\$ 75,480	\$ 70,005	\$ 5,760	\$ 12,500

6. EARNINGS PER SHARE

Basic earnings per share are based on net income and a simple weighted average of Class A and Class B Common Shares and director stock units outstanding. Diluted earnings per share reflect the potential dilution of Class A Common Shares related to outstanding stock options and restricted stock units. The numerator for the diluted earnings per share calculation is net income. The denominator is the weighted average diluted shares outstanding.

Three Months Ended		Six Months Ended	
August 2, 2008	August 4, 2007	August 2, 2008	August 4, 2007
(in thousands)			