

GOLFSMITH INTERNATIONAL HOLDINGS INC

Form 10-K

March 30, 2007

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

(Mark One)

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

For the fiscal year ended December 30, 2006

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 78753

(Address of Principal Executive Offices)

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

Securities Registered Pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock, \$0.01 par value

The Nasdaq Stock Market

Securities Registered Pursuant to Section 12(g) of the Act: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes No

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 Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold as of the last business day of the Registrant's most recently completed second fiscal quarter was approximately \$67.1 million. Aggregate market value excludes an aggregate of 9,068,005 shares of common stock held by officers and directors and by each person known by the Registrant to own 5% or more of the outstanding common stock on such date. Exclusion of shares held by any of these persons should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the Registrant, or that such person is controlled by or under common control with the Registrant.

There were 15,722,993 shares of the registrant's common stock issued and outstanding as of March 15, 2007.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the registrant's 2007 Annual Meeting of Stockholders are incorporated by reference in this Form 10-K

GOLFSMITH INTERNATIONAL HOLDINGS, INC.

**Annual Report on Form 10-K
For the Fiscal Year Ended December 30, 2006**

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COMPANY INFORMATION

Golfsmith International Holdings, Inc. was formed on September 4, 2002 and became the parent company of Golfsmith International, Inc. on October 15, 2002 when it acquired all of the outstanding stock of Golfsmith International, Inc. Golfsmith International Holdings, Inc. is a holding company and has no material assets other than all of the capital stock of Golfsmith International, Inc. In this Annual Report, unless the context indicates otherwise, the term Golfsmith refers to Golfsmith International, Inc. and its subsidiaries. The term Golfsmith Holdings refers to Golfsmith International Holdings, Inc. and its subsidiaries. The terms we, us and our refer to Golfsmith prior to its acquisition by Golfsmith Holdings and to Golfsmith Holdings after giving effect to the acquisition of Golfsmith. Our principal executive office is located at 11000 N. IH-35, Austin, Texas 78753-3195, and our telephone number is (512) 837-8810. Our Internet site address is www.golfsmith.com.

CAUTIONARY NOTICE REGARDING FORWARD LOOKING STATEMENTS

This Annual Report on Form 10-K contains forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events. These statements include but are not limited to:

the timing, amount and composition of future capital expenditures;

the timing and number of new store openings and our expectations as to the costs associated with new store openings;

the timing and completion of the remodeling of our existing stores; and

our plans to grow particular areas of our business, including sales of our proprietary-branded products, our apparel and tennis products.

These statements may be found in the sections of this Annual Report entitled Risk Factors, Management's Discussion and Analysis of Financial Condition and Results of Operations and Business and in this Annual Report generally, including the sections of this Annual Report entitled Business Overview and Business Industry, which contain information obtained from independent industry sources. Actual results could differ materially from those anticipated these forward-looking statements as a result of various factors, including all the risks discussed elsewhere in this Annual Report.

In addition, statements that use the terms believe, expect, plan, intend, estimate, anticipate and similar intended to identify forward-looking statements. In addition other statements may also be forward-looking statements. All forward-looking statements in this Annual Report reflect our current views about future events and are based on assumptions and are subject to risks and uncertainties that could cause our actual results to differ materially from future results expressed or implied by the forward-looking statements. Many of these factors are beyond our ability to control or predict. You should not put undue reliance on any forward-looking statements. Unless we are required to do so under U.S. federal securities laws or other applicable laws, we do not intend to update or revise any forward-looking statements.

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PART I

Item 1. Business

Overview

We believe that we are the nation's largest specialty retailer of golf and tennis equipment, apparel and accessories based on sales. Since our founding in 1967, we have established Golfsmith as a leading national brand in the golf retail industry. We operate as an integrated multi-channel retailer, providing our customers, whom we refer to as guests, the convenience of shopping in our 65 stores across the nation, through our Internet site, *www.golfsmith.com*, and from our catalogs. Our stores have knowledgeable employees, whom we refer to as caddies, and feature an activity-based shopping environment where our guests can test the performance of golf clubs in our in-store hitting areas. We offer an extensive product selection that features premier national brands as well as our proprietary products and pre-owned clubs. We also offer a number of guest services and customer care initiatives including our SmartFit™ custom club-fitting program, in-store golf lessons, our club trade-in program, our 90-day playability guarantee, our 115% low-price guarantee and our proprietary credit card. Our distribution and fulfillment center and management information systems support and integrate our distribution channels and provide a scalable platform to support our planned expansion.

We began as a clubmaking company, offering custom-made clubs, clubmaking components and club repair services. In 1972, we opened our first retail store and, in 1975, we mailed our first general golf products catalog. Over the next 25 years, we continued to expand our product offerings, opened larger retail stores and expanded our direct-to-consumer business by adding to our catalog titles. In 1997, we launched our Internet site to further expand our direct-to-consumer business. In October 2002, an investment fund managed by First Atlantic Capital, Ltd. acquired us from our original founders, Carl, Barbara and Franklin Paul and continues to retain a majority ownership interest in us. In June 2006, we completed our initial public offering and listing on the Nasdaq Global Market.

Store Operations

We opened our first retail store in 1972 and currently operate 65 stores in 15 states. The locations of our stores are more fully described in Item 2, Properties.

We design our stores to provide an exciting, activity-based shopping environment that resonates with the golf and tennis enthusiast and highlights our extensive product offering. To date, we have determined that, in most locations, our store concept is best suited to an 18,000 to 22,000 square foot format, although in certain locations we operate stores outside of this range. In addition, in the future we may determine to open new stores outside of this basic range depending on local market demographics, competition, real estate prices and availability.

Each Golfsmith store offers a full line of premier-branded clubs, balls, apparel and accessories, as well as our proprietary-branded products. The majority of our stores also offer club components, clubmaking tools, supplies and on-site clubmaking, custom club-fitting, club repair services as well as tennis racket stringing. Our stores incorporate technology, lessons and club demos in a range-like setting. All of our stores offer hitting areas, putting greens and ball-launch monitor technology. Our larger stores provide a more expansive array of activity-based offerings including partial-flight indoor driving ranges and a wider assortment of demo clubs.

We have entered into an agreement with GolfTEC Learning Centers to provide precision club-fitting and PGA-certified golf instruction to our guests. We had GolfTEC Learning Centers in 38 of our 62 stores as of December 30, 2006.

We intend to expand our store base selectively in existing and new markets in locations that fit our selection criteria, which include:

demographic characteristics, such as above-average annual household income and a high number of golfers who play 25 or more rounds per year (avid golfers);

presence and strength of competition;

visibility from and access to highways or other major roadways;

the level of our penetration in a given market, either through our existing retail stores or our direct-to-consumer channel;

original equipment manufacturer information indicating that the location is a top sales market;

proximity to a large metropolitan area;

the ability to obtain favorable lease terms; and

Big Box retail co-tenants that are likely to draw guests to our locations.

After we identify a potential site, we analyze demographic and competitive data to project store revenues and develop profitability forecasts.

Our stores accounted for 74.0% of our net revenues in fiscal 2006, 72.3% in fiscal 2005 and 69.0% in fiscal 2004.

From January 2004 to December 2006, we increased the number of our stores from 38 to 62.

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Direct-to-Consumer

Our direct-to-consumer channel consists of our Internet and catalog businesses. Through our direct-to-consumer distribution channel, we offer our guests a complete line of golf and tennis products, including equipment, apparel and accessories, as well as clubmaking components and tools. Our direct-to-consumer channel accounted for 23.8% of our net revenues in fiscal 2006, 25.7% in fiscal 2005 and 28.5% in fiscal 2004. The decrease in the percentage of our net revenues derived from our direct-to-consumer channel correlates with our increased number of stores and the related growth in net revenues.

Internet

We offer over 31,000 golf and tennis stock keeping units (SKU s) through our Internet site, www.golfsmith.com, which we began in 1997. We also have 31 registered domain names that link to www.golfsmith.com including two which are linked to our European website and one to our Canadian website.

Through our Internet site, we seek to extend to the direct-to-consumer channel the innovative services offered in our stores. We have further enhanced the guest shopping experience by featuring, among other items, the following:

online SmartFit™ system - allows our guests to custom-fit their golf clubs to their personal specifications by providing step-by-step instructions to walk them through the online club-fitting process,

tips on equipment provides guidance on how to select appropriate golf and tennis equipment,

product personalization services allows guests to order personalized merchandise,

in-store pickup allows guests to order an item online and avoid the delivery expenses and waiting time,

store and item locator allows guests to enter the zip code and locate the store nearest to them in which a selected item is in stock,

pre-owned club information provides our guests with full access to our pre-owned club selection, including detailed information about the type of club and its condition,

Club Trade-In Program allows guests to trade in their used clubs and receive a merchandise credit for the value of the clubs in exchange,

Drive section is specifically designed for the woman golfer,

tennis section - includes a detailed buyer's guide to assist both tennis enthusiasts and recreational tennis players in making their purchases,

search functionality allows guests to search for an item of apparel by a specific category, color, brand or material,

product reviews - allows guests to post and read reviews of any product that we offer, and

trip and vacation planner allows guests to use our website to plan their golfing vacations, including booking airplane, hotel and rental car reservations, and,

In addition, in February 2007, we partnered with ESPN to make Golfsmith.com the official golf and tennis pro shop of ESPN.com. Under the agreement, each ESPN.com golf and tennis page will feature promotions and links to Golfsmith.com. We will be providing marketing, customer service and product distribution to ESPN.com golf and tennis shoppers.

We believe our Internet site complements our retail stores and catalogs by building guest awareness of our brand and acting as an effective marketing vehicle for new product introductions, special product promotions and our

proprietary-branded products. We believe that our Internet site also drives traffic to our stores, as evidenced by the fact that one of the most-used features on the Internet site is the store-locator functionality.

Catalogs

We have a 40-year history as a catalog retailer and believe that we are one of the industry's leading golf specialty catalog retailers based on circulation. Our principal catalog publications are the Golfsmith Consumer Catalog, targeting the avid male golfer, and the Golfsmith Clubmaking Catalog, a specialty catalog for people who build their own clubs. In 2005, we launched our first Annual Buyer's Guide, designed to be the most extensive and informative catalog of golf-related equipment and accessories, providing pictures and descriptions of many of the 15,000 SKUs offered in 216 pages. In the same year, we launched our Drive catalog, targeted specifically to the women golfer and offering fashionable apparel and state-of-the-art golf equipment. In fiscal 2006, we premiered our Center Court tennis catalog, which carries major brands of tennis equipment, apparel and accessories. Beyond shopping in our stores and on our website, we believe the Center Court tennis catalog will help support and grow our relationship with core tennis enthusiasts.

Our catalog titles are designed and produced by our in-house staff of art directors, writers and photographers. The monthly production and distribution schedule of our consumer catalogs permits us to introduce new products regularly and make price adjustments as necessary. Our continued strategy of producing more targeted catalog vehicles follows the industry trend towards developing more

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niche, targeted publications for customers.

Our customer database contains approximately 2.9 million names of guests who have purchased our products since 2000, as well as other individuals who have requested to receive our periodic mailings. We have developed this database largely through our catalog and website order-processing and, to a lesser extent, through contests and point-of-sale data collection in our stores. We use statistical evaluation and selection techniques to determine which guest segments are likely to contribute the greatest revenues per mailing.

Products and Merchandising

We offer a broad assortment of golf and tennis brands and products, including our own proprietary brands, through our sales channels. We generally price our products consistently across our channels. We also tailor the merchandise selection in our particular stores to meet the regional preferences of our guests. By providing a wide-ranging, in-depth assortment, we believe we will continue to attract the full spectrum of guests from avid to recreational golfers as well as both tennis enthusiasts and recreational tennis players with buying interest across all price points.

Technological cycles

Substantial technological advancements in equipment over the past decade have shortened product replacement cycles and increased prices. Significant advances have been achieved in club head, shaft and golf ball construction, design and materials. The recent popularity of utility or hybrid clubs, a category of clubs that combines elements of both woods and irons into their design is driving another product replacement cycle. The introduction of new and improved products, together with advertising and promotions by equipment manufacturers and retailers emphasizing the importance of proper equipment to one's game, has encouraged golfers to change their equipment more frequently.

Branded Products

We are a retailer of premier-branded golf and tennis merchandise. We believe that carrying a broad selection of the latest premier-branded merchandise is critical to driving business with our highest-spending and most passionate guests, the avid golf and tennis player.

Clubs. We carry a wide variety of premier-branded golf clubs from leading national manufacturers catering to both avid and recreational golfers. We have continued to increase our assortment of pre-owned premier-branded clubs as we have expanded our Club Trade-in program. This has enabled us to provide value-conscious guests with additional price-points on premium branded clubs. The premier golf club brands that we offer include, among others, Callaway, Cleveland, Cobra, Nike, Ping, TaylorMade, and Titleist.

Apparel and footwear. We offer a range of golf and tennis apparel including shirts, sweaters, vests, pants, shorts and outerwear along with such accessories as jewelry, watches and leather goods from such premier brands as adidas, Ashworth, Ben Hogan, Callaway, Greg Norman, Nike and Ping. We also offer footwear for both golf and tennis for men, women and juniors from top national brands such as adidas, Bite, Callaway, Ecco, Etonic, FootJoy, Lady Fairway, Nike, Oakley, Prince and Wilson.

Golf balls. We offer a broad range of nationally recognized golf ball brands including Bridgestone, Callaway, Maxfli, Nike, Titleist, and Top-Flite. These premier-branded golf balls provide our guests with the ability to select products that suit their desire for distance and control.

Accessories. We provide an extensive range of golf and tennis accessories to support our guests' golf and tennis activities including technology devices such as Global Position System (GPS) range finder units and other golf and tennis accessories, such as tees, sunglasses, cleaning and repair kits, towels, tennis bags, tennis strings and golf cart heaters. The premier brands of the accessories that we offer include Bushnell, Coleman, Head, Nike, Oakley, Prince, SkyHawk, Team Effort and Wilson.

Racquets. We offer a variety of premier national tennis racquet brands, such as Babolat, Head, Prince, Völkl and Wilson.

Golfsmith Proprietary Brands. Our proprietary trademarks and service marks include Golfsmith[®], Black Cat[®], Crystal Cat[®], Killer Bee[®], Lynx[®], Parallax[®], Predator[®], Snake Eyes[®], Tigress[®], Zevo[®], ASI[™], GearForGolf[™], GiftsForGolf[™], J.G.H.[™] and VictorScot[™]. In fiscal 2006, our proprietary-branded products accounted for \$53.3 million of our net sales. We maintain proprietary merchandise in a number of categories including apparel, club, golf bags, shoes and other accessories. In October 2006, we entered into an exclusive partnership with world-renowned PGA Teaching Professional Hank Haney to create a comprehensive line of golf-training aids to

further enhance our proprietary product offerings.

Our proprietary brands provide quality products at attractive prices and generally have higher gross margins than the premier-branded products we offer. We control the product development of our proprietary brands through our internal research and development team. In addition, through our proprietary branded products, we are able to appeal to custom clubmakers and enhance our status as equipment design experts.

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We position our proprietary-branded products to target a different customer base so as not to compete directly with the premier-branded merchandise that we offer. While the premier-branded merchandise we offer generally attracts avid golfers who are typically less value-conscious, our proprietary brands generally serve our more value-conscious guests. By maintaining an inventory of premier-branded merchandise and our proprietary brands, we are able to supply our guests a broad assortment of products along a continuum of price points.

Club Components

We offer a large selection of club components, including club heads (consisting primarily of our proprietary brands), shafts and grips, from the premier national brands in club components, including Aldila, Fujikura, Golf Pride, Lamkin, Royal Precision, True Temper, UST and Winn.

Seasonality

Our sales and net operating income are typically driven by the periods during the year that include the warm weather months and the December holiday gift-giving season.

Customer Care Initiatives

We offer our guests the following initiatives to foster their loyalty and promote confidence in their purchases:

90/90 Playability Guarantee. This initiative allows our guests to purchase and use certain clubs for up to 90 days and to return the clubs for a merchandise credit equal to 90% of the price if they aren't satisfied with it.

115% Price Guarantee. We offer a 115% low price guarantee whereby we will refund 115% of the difference in purchase price if a guest notifies us within 30 days of purchase of a lower price offered by another authorized retailer.

Club Trade-Ins. Our Club Trade-In Program allows guests to receive a merchandise credit for their pre-owned clubs which can be applied toward the purchase price of new clubs or other products. Guests can trade in their clubs at any store, through our internet site or through our catalog. Our Club Trade-In Program is enhanced by periodic initiatives such as our National Trade-In Days program where guests are given additional value for trading in their used clubs.

Golfsmith Credit Card. We offer our own proprietary credit card, which provides our qualified guests with flexible payment options such as no interest, no payments for six or 12 months, for their Golfsmith purchases. As a result of our partnership with a national financial institution, we do not bear any of the financing risk associated with this program.

Loyalty Program. In April 2006, we launched our Player Rewards loyalty program to attract and retain guests that shop five or more times per year for either golf or tennis merchandise across all of our channels. The program is free to all guests and provides members with advance notice of sales and special events, exclusive invitations to VIP-only events, special pricing on select items, trade-in bonuses and coupons and discounts on select products and services.

As part of our guest-first philosophy, we also provide our guests with a number of other golf and tennis-related services, including the following:

SmartFit Custom Club Fitting Program. We offer guests the ability to custom-fit their clubs through our SmartFit™ program. Through our SmartFit™ program, we customize premier and proprietary-branded clubs to the guest's physical profile (height, wrist-to-floor distance and hand size), swing speed and the guest's desired game characteristics (trajectory, control and distance). We also have the ability to custom build a set of golf clubs from scratch using our clubmaking technology and components. Our SmartFit™ program is available to our guests at every store, as well as through our Internet site.

GolfTEC Learning Centers. Our relationship with GolfTEC Learning Centers complements our in-store caddy team by providing in-store golf instruction. GolfTEC's proprietary system features digital video, motion analysis and ball-flight projection to allow its staff of PGA-certified teaching pros to analyze our guest's swing

and compare it to a database of the

swings of various professional golfers. In addition, GolfTEC provides software that enables guests to review their lesson, drills and instructor comments online. Guests participation in GolfTEC lessons drives traffic within our stores as our guests buy lesson packages that encourage repeat visits to our store location. As of December 2006, GolfTEC provided in-store golf lessons in 38 of our stores.

Club Repair and Clubvantage Program. We offer club repair services at all of our stores. In addition we sell two- and three-year plans under our Clubvantage program that provide for all labor costs for re-gripping, re-shafting and repairing individual clubs or club sets. The program provides additional benefits, such as an additional credit on any clubs that are traded in and a savings certificate for the Harvey Penick Golf Academy.

Expert Racquet Stringing. As a member of the U.S. Racquet Stringers Association, we are able to offer our guests expert racquet stringing services. Our professionally-trained Master Racquet Technicians have passed comprehensive tests to ensure their knowledge and understanding of racquet service. Our Master Racquet Technicians provide our guests with a full range of racquet services and answer their racquet-related questions.

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Customer Service

We strive play the role of caddy to our guests through our caddy for life philosophy. Through this guest services philosophy we believe we have developed a culture that has enabled us to cultivate a strong and loyal customer base. In order to encourage a knowledgeable caddy team, we actively recruit golfing and tennis enthusiasts to serve as sales associates, because we believe that they bring enthusiasm to the shopping experience and are knowledgeable about the products they sell. We also target individuals with a strong retail background, because we believe a general understanding of retail sales is critical for marketing and selling our products.

We emphasize product knowledge at both the hiring and training stages. As part of our interview process, we test each prospective sales associate for knowledge specific to the department in which he or she is to work.

In 2006, a component of our caddies compensation was based on sales commissions, which we believe motivates them to learn more about our product and service offerings and to demonstrate and explain to our guests the features and benefits of our products and services. Our commission system is designed to ensure that our caddies focus on providing the products or services that are well suited to our guests. Like many retailers, we believe that this approach allows us to recruit and retain an educated and professional sales force that leads to a better guest experience.

Marketing and Advertising

Our marketing and advertising programs are designed to promote our extensive selection of premier national brands as well as our own proprietary brands at competitive prices. Through our integrated marketing and advertising, we emphasize our multi-channel business model by utilizing our in-store, catalog and Internet capabilities to promote our brand and advertise our innovative services and events.

We employ a combination of print, broadcast, radio, direct mail, e-mail and billboard media, as well as in-store events, to drive awareness of our brand. On the local level, we run newspaper advertisements to promote stores and store events. The clustering of stores in particular markets allows local advertising techniques to be more successful and cost-effective. On the national level, we run printed advertisements in national magazines, such as Golf Digest, Golf World and Golf for Women. In the past, we have run national advertisements on The Golf Channel and local television advertisements in select markets to complement our direct marketing campaign. To manage costs and increase effectiveness, we have expanded the use of e-mail for direct marketing.

The catalogs and magazines that we distribute throughout the year are also an important marketing tool. In 2006, we mailed more than 11 million catalogs. We believe that our catalogs drive online and in-store traffic and also expand recognition of the Golfsmith[®] brand.

We employ additional marketing activities prior to key shopping periods, such as Father's Day and the December holidays, and in connection with specific sales and promotions. In particular, we hold various theme- or activity-based promotions throughout the year that drive additional traffic into our stores, including demonstration days, appearances by PGA golfers, tour vans and events focusing primarily on the female guest. To reinforce our multi-channel model, we coordinate these events across both our retail store and direct-to-consumer channels.

In April 2006, we launched our Player Rewards loyalty program, which we believe further fosters guest loyalty and also provides us with valuable market intelligence and purchasing information regarding our most frequent guests. We use this information to focus our advertising efforts, encourage repeat shopping and communicate with our target customers.

Management Information Systems

Our management information systems provide us with a network and applications that are reliable, scalable and easy to use, maintain and modify. Our management information systems are based on the Oracle ERP system with additional integrated systems. This infrastructure integrates major aspects of our business across our selling channels, improves our back-office capabilities, enhances management reporting and analysis capabilities and expands our direct marketing capabilities.

Our in-store, point-of-sale system tracks all sales by category, style and item and allows us to routinely compare current performance with historical and planned performance. The information gathered by this system also supports automatic replenishment of inventory and is integrated into product buying decisions. The system has an intuitive, user-friendly interface that minimizes new user training requirements, allowing our caddies to focus on serving our guests.

The majority of our hardware resides at our corporate headquarters. We have implemented redundant servers and communication lines to limit downtime in the event of power outages or other potential problems. System administrators and network managers monitor

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and operate our network operations and transactions-processing systems to ensure the continued operation of our Internet site and transaction-processing systems. Our focus on reliability, availability and scalability has supported our operations and the continued addition of stores during 2006 and through the first quarter of fiscal 2007, without causing any interruptions to our point-of-sale system.

Purchasing

Over our 40-year history in the golf business, we have developed relationships with many of the major equipment vendors in the industry giving us a diverse network of suppliers. In each of the 2005 and 2006 fiscal years, three of our suppliers, Callaway Golf, TaylorMade / adidas Golf and Acushnet each individually supplied at least 10% of our consolidated purchases. We source substantially all of our proprietary products from contract manufacturers in Asia, which manufacture our equipment according to our specifications. We do not have long-term supply contracts with our vendors, and all of our orders are made on a purchase-order basis.

Many of our vendors provide us with volume purchasing rebates if we reach certain order targets. Additionally, our ability to resell pre-owned equipment and purchase large quantities of the prior year's models, called power buys, solidifies our relationship with our vendors.

In 2005 we initiated an annual co-operative advertising program pursuant to which the cost of marketing certain vendors' products or services is reimbursed by the vendor. This program offers our vendors differentiated co-operative advertising opportunities due to our multi-channel business model and activity-based store environment. We work closely with our vendors to find co-operative opportunities and negotiate mutually beneficial terms. Along with vendor buy-ins to sponsor events, these cross-promotional arrangements have enabled us to expand our own marketing activities as a result of vendor reimbursement of marketing expenses related to their products.

Distribution and Fulfillment

We have developed a hybrid distribution system that combines our central warehouse and distribution infrastructure with the direct-ship expertise of the vendor community. This hybrid distribution model increases our flexibility to allocate inventory to stores on an as-needed basis, which improves our in-stock positions.

We operate a 240,000 square-foot distribution and fulfillment center in Austin, Texas, which handles selected store inventory replenishment and substantially all direct-to-consumer order fulfillment requirements. Store inventory replenishment is accomplished using a warehouse management system that separates and collates shipments which are trucked to our stores by a third-party dedicated fleet. For those vendors whose infrastructure supports direct shipment to retail locations, our hybrid system also allows for a direct-ship component.

We dedicate 100,000 square feet of our distribution and fulfillment center to our direct-to-consumer shipping facility, which can handle over one million packages annually. This facility utilizes advanced technology, including an automated conveyor system that efficiently moves merchandise through the picking and shipping areas. While most direct-to-consumer orders are filled from this facility, our information systems allow us to search store inventory if the distribution and fulfillment center is out of stock. If needed, pick tickets are automatically generated at the appropriate store, and store caddies ship the product directly to the guest. This capability allows us to optimize our use of inventory across our supply chain and increases our order fill rates.

We also have two smaller distribution facilities near London, England and in Toronto, Canada, from which we service our European and Canadian guests, respectively.

International

We work with a group of international agents and distributors to offer golf club components and equipment to clubmakers and golfers in selected regions outside the United States. In the United Kingdom, we sell our proprietary-branded equipment through a commissioned sales force directly to retailers. Throughout most of Europe and parts of Asia and other parts of the world, we sell our products through a network of agents, distributors and through our website. Sales through our international distributors and our distribution and fulfillment center near London, England accounted for 1.6% of our net revenues in fiscal 2006, 1.5% in fiscal 2005, and 2.2% in fiscal 2004.

Harvey Penick Academy

In 1993, we partnered with Austin, Texas, native and golf instructor, the late Harvey Penick, to form the Harvey Penick Golf Academy. The academy has attracted over 21,000 students since its inception. We believe the academy helps contribute to sales at our adjacent Austin store. The academy accounted for approximately 0.2% of our net

revenues in fiscal 2006, 0.2% of our net revenues in fiscal 2005, and 0.3% in fiscal 2004.

Table of Contents**Competition**

The golf industry is highly fragmented and competitive. We compete both in the off-course specialty retail segment and in the online and catalog retail segment. The off-course specialty retail segment is characterized by sales of golf equipment and apparel, a unified store image, favorable pricing and knowledgeable staff. The online and catalog retail segment is characterized by competitive pricing, shopping convenience and a wide product selection.

Off-course specialty retailers. Due to the fragmented nature of the golf industry, off-course specialty retail stores vary significantly in size, strategy and geographic location. Some focus on specific areas of the country, and some have focused more heavily on a single channel, being slow to develop into other channels of commerce or develop multi-channel expertise. Our primary competitors in this category are Edwin Watts, Golf Galaxy and PGA Tour Superstore.

Online and catalog retailers of golf equipment. Online and catalog retailers of golf equipment sell a wide selection of merchandise through the use of catalogs and the Internet. The products are competitively priced and the direct channel offers a certain convenience to consumers. However, catalog and Internet-only retailers are not able to offer hands-on product testing and fitting. These retailers typically have a limited channel focus that limits their ability for cross-channel marketing and sales as well as for cross-channel brand promotion. Our primary competitors in this category are The Golf Warehouse and Edwin Watts.

Franchise and independent golf retailers. Franchise and independent golf retailers tend to be comprised of smaller stores with 2,000 to 5,000 square feet and generally are not positioned in major markets. Due in part to their more limited space and their position outside major markets, we believe these stores generally offer a less extensive selection of golf clubs, equipment, accessories and apparel. Many promote sales of their private label or lesser-known brands. They also do not typically have PGA-certified professionals assisting guests or advanced demonstration and testing facilities. Our main competitors in this category include Nevada Bob's, Roger Dunn Golf Shops, Pro Golf Discount and Golf USA.

On-course pro shops. On-course pro shops are located on-site at golf courses or on-site at other golf facilities such as driving ranges. These retailers have significantly smaller stores with which to offer merchandise. While these shops generally have PGA professionals on staff, they generally offer a less extensive selection of golf clubs and equipment, choosing to devote more of their limited space to showcasing apparel. These shops also generally do not offer advanced demonstrations or diagnostic or testing equipment such as ball launch monitors.

Conventional sporting goods retailers. Conventional sporting goods retailers are generally large format 20,000 to 100,000 square foot stores that offer a wide range of sporting goods merchandise covering a variety of categories, including merchandise related to most professional sports. These stores apply a single store format to numerous specialty areas. Prices at these stores are generally competitive, but we believe that the limited space they devote to golf products restricts the breadth of their golf offering. These retailers often do not have full access to all of the premier national brands and to the full assortment of those brands' lines. Most do not currently have PGA-certified professionals, advanced demonstration and trial facilities or club repair services. Our main competitors in this category are Dick's Sporting Goods and The Sports Authority.

Mass merchants and warehouse clubs. These stores typically range in size from 50,000 to 200,000 square feet and above. These merchants and clubs offer a wide-range of products, but golf merchandise tends to represent a very small portion of their retail square footage and their total sales. We believe that their limited product selection and limited access to the range of premier national brands does not appeal to many golf enthusiasts. These stores also do not focus on services which address the needs of golfers specifically. Examples of such stores are Wal-Mart, Target and Costco.

Facilities

With the exception of our corporate headquarters in Austin, Texas and the store at our corporate headquarters, all premises are held under long-term leases with differing provisions and expiration dates. Our lease rents are generally fixed amounts with increases over the terms, and some leases include percentage rent requirements based on sales. Most of our leases contain provisions permitting us to renew for one or more specified terms.

We own a 41-acre Austin, Texas campus, which is home to our corporate headquarters, including general offices, distribution and fulfillment center, contact center, clubmaker training facility and the Harvey Penick Golf Academy. The Austin campus also includes an equipment testing and practice area.

Details of our facilities are more fully described in Item 2, Properties of this Annual Report on Form 10-K.

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Proprietary Rights and Intellectual Property

We are the registrant of, or have pending registrations for, over 90 trademarks and service marks in more than 25 countries including Golfsmith[®], ASI[™], Black Cat[®], Crystal Cat[®], Dry18[™], GearForGolf[™], GiftsForGolf[™], JG Hickory[™], Killer Bee[®], Lynx[®], Parallax[®], Predator[®], Snake Eyes[®], Tigress[®], TourTrek[™], VictorScot[™] and Zevo[®]. We are also the owner of 31 registered domain names. We believe that our trademarks and service marks have important value and are integral to building our name recognition.

Employees

We typically staff our stores with a general manager, up to two assistant managers and, on average, 15 to 20 full-time and part-time sales staff depending on store volume and time of year. As of December 30, 2006, we employed approximately 880 full-time and 660 part-time personnel. We generally supplement our workforce with seasonal full-time and part-time workers at peak times during our second and fourth quarters. None of our work force is unionized.

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Item 1A. Risk Factors

A reduction in the number of rounds of golf played and the popularity of golf or tennis may adversely affect our sales.

We generate substantially all of our net revenues from the sale of golf and tennis equipment, apparel and accessories. The demand for golf and tennis 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. According to the National Golf Foundation, the number of rounds played annually in the United States declined from 518.4 million in 2000 to 501.3 million in 2005. We believe that this decline is attributable to a number of factors, including the state of the nation's economy. If golf participation and the number of rounds of golf played decreases, sales of our products may be adversely affected. We cannot assure you that the overall dollar volume of the market for golf and tennis-related products will grow, or that it will not decline, in the future.

The demand for golf products is also directly related to the popularity of magazines, cable channels and other media dedicated to golf, television coverage of golf tournaments and attendance at golf events. We depend on the exposure of the products we sell, especially the premier-branded golf merchandise, through advertising and the media or at golf tournaments and events. Any significant reduction in television coverage of, or attendance at, golf tournaments and events or any significant reduction in the popularity of golf magazines or golf channels, may reduce the visibility of the brands that we sell and could adversely affect our sales of golf products.

We may be unable to expand our business if adequate capital is not available.

Our ability to open new stores depends on the availability of adequate capital, which in turn depends in large part on our cash flow from operations and the availability of equity and debt financing. We currently anticipate spending approximately \$1.8 million to open each additional store, which includes pre-opening expenses, capital expenditures and inventory costs. These expenditures can vary depending on the store's size, geographic market conditions and the level of work required for the property when received from the landlord. We cannot assure you that our cash flow from operations will be sufficient or that we will be able to obtain equity or debt-financing on acceptable terms or at all to implement our growth strategy.

On June 20, 2006, we completed an initial public offering of our common stock. Our stock trades on the Nasdaq Global Market under the ticker symbol GOLF. In the initial public offering, we sold 6,000,000 shares of common stock and received net proceeds of \$61.2 million. We used these net proceeds along with borrowings under our Amended and Restated Credit Facility to retire our Senior Secured Notes with a face value of \$93.75 million, to repay the entire outstanding balance of our Old Senior Secured Credit Facility, to pay fees and expenses related to our Amended and Restated Credit Facility and to pay a \$3.0 million fee to terminate our management consulting agreement with First Atlantic Capital, Ltd. The completion of the initial public offering and concurrently, the completion of the Amended and Restated Credit Facility that provides for borrowings up to \$65.0 million, provides us with increased financial flexibility that we believe will be helpful in executing our growth plans.

The Amended and Restated Credit Facility contains provisions which restrict our ability to incur additional indebtedness, make capital expenditures, or make substantial asset sales which might otherwise be used to finance our expansion. Our obligations under the Amended and Restated Credit Facility are secured by substantially all of our assets, which may further limit our access to capital or lending sources. As a result, we cannot assure you that we will have adequate capital to finance our current expansion plans.

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

Golf products are recreational in nature and are therefore discretionary purchases for consumers. Consumers are generally more willing to make discretionary golf product purchases during favorable economic conditions. Discretionary spending is affected by many factors, including general business conditions, interest rates, the availability of consumer credit, taxation and consumer confidence in future economic conditions. Purchases of our products could decline during periods when disposable income is lower, or during periods of actual or perceived unfavorable economic conditions. Any significant decline in general economic conditions or uncertainties regarding future economic prospects that adversely affect discretionary consumer spending, whether in the United States generally or in a particular geographic area in which one or more of our stores are located, could lead to reduced sales of our products.

Our sales and profits may be adversely affected if we or our suppliers fail to develop and introduce new and innovative products that appeal to our customers.

Our future success depends, in part, upon our and our suppliers' continued ability to develop and introduce new and innovative products. This is particularly true with respect to golf clubs, which accounted for approximately 46% and 45% of our net revenues in fiscal 2006 and 2005, respectively. We believe our guests desire to test the performance of the latest golf equipment drives traffic into our stores and increases sales. This is particularly true when significant technological advances in golf clubs and other equipment occur, although such advances generally only occur every few years. Furthermore, the success of new products depends not only upon their performance, but also upon the subjective preferences of golfers, including how a club looks, sounds and feels, and the level of popularity that a golf club enjoys among professional and recreational golfers. Our success depends, in large part, on our and our suppliers' ability to identify and anticipate the changing preferences of our customers and our ability to stock our stores with a wide selection of merchandise that appeals to customer preferences. If we or our suppliers fail to successfully develop and introduce on a timely basis new and innovative products that appeal to our customers, our revenues and profitability may suffer.

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On the other hand, if 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 and financial condition.

Competition from new and existing competitors could have an adverse effect on our sales and profitability.

Our principal competitors are currently other off-course specialty retailers, franchise and independent golf retailers, on-course pro shops, conventional sporting goods retailers, mass merchants and warehouse clubs, and online and catalog retailers of golf equipment. These businesses compete with us in one or more product categories. In addition, traditional sports retailers and specialty golf retailers are expanding more aggressively in marketing and supplying brand-name golf equipment, thereby competing directly with us for products, customers and locations. Some of these competitors have greater financial or marketing resources than we do and may be able to devote greater resources to sourcing, promoting and selling their products. We may also face increased competition due to the entry of new competitors, including current suppliers that decide to sell their products directly. 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 margins and our results of operations in general.

Our growth will be adversely affected if we are unable to open new stores and operate them profitably.

Our growth strategy involves opening additional stores in new and existing markets. We are in the early stages of our store expansion. At December 30, 2006, we had 62 stores, of which over 40% were opened in the past three fiscal years. We currently plan to open between 12 and 14 additional new stores in 2007. In addition to capital requirements, our ability to open new stores on a timely and profitable basis is subject to various contingencies, including but not limited to, our ability to successfully:

identify suitable store locations that meet our target demographics;

negotiate and enter into long-term leases upon acceptable terms;

build-out or refurbish sites on a timely and cost-effective basis;

hire, train and retain skilled managers and personnel; and

integrate new stores into existing operations.

After identifying a new store site, we typically try to negotiate a long-term lease, generally between 10 and 20 years. Long-term leases typically result in long-term financial obligations that we are obligated to pay regardless of whether the store generates sufficient traffic and sales. There can be no assurance that new stores will generate sales levels necessary to achieve store-level profitability or profitability comparable to that of existing stores. New stores may also have lower sales volumes or profits compared to previously opened stores or they may have losses. In the past, we have experienced delays and cost-overruns in obtaining proper permitting, building and refurbishing stores. We cannot assure you that we will not experience these problems again, from time to time, in the future.

Furthermore, our expansion into 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 activity-based store design and concept, added strain on our distribution and fulfillment center and management information systems, and diversion of management attention from existing operations.

We cannot assure you that we will be successful in meeting the challenges described above or that any of our new stores will be a profitable deployment of our capital resources. If we fail to open additional stores successfully or if any of our new stores are not profitable, we may not be able to grow our revenues and our results of operations and financial position may be adversely affected.

If our key suppliers limit the amount or variety of products they sell to us or if they fail to deliver products to us in a timely manner and upon customary pricing and payment terms, our sales and profitability may be reduced.

We rely on a limited number of suppliers for a significant portion of our product sales. During fiscal 2005 and 2006, three of our suppliers each accounted for at least 10% of our purchases. We depend on access to the latest golf equipment, apparel and accessories from the premier national brands in order to attract traffic into our stores and through our direct-to-consumer channel. We do not have any long-term supply contracts with our suppliers providing for continued supply, pricing, allowances or other terms. In addition, certain of our vendors have established minimum advertised pricing requirements, which, if violated, could result in our inability to obtain certain products. If our suppliers refuse to distribute their products to us, limit the amount or variety of products they make available to us, or fail to deliver such products on a timely basis and upon customary pricing and payment terms, our sales and profitability may be reduced.

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In addition, some of our proprietary products require specially developed manufacturing molds, techniques or processes which make it difficult to identify and utilize alternative suppliers quickly. Any significant production delay or the inability of our current suppliers to deliver products on a timely basis, including clubheads and shafts in sufficient quantities, or the transition to alternate suppliers, could have a material adverse effect on our results of operations.

Our sales could decline if we are unable to process increased traffic or prevent security breaches on our Internet site and our network infrastructure.

A key element of our strategy is to generate high-volume traffic on, and increase sales through, our Internet site. Accordingly, the satisfactory performance, reliability and availability of our Internet site, transaction processing systems and network infrastructure are critical to our reputation and our ability to attract and retain guests. Our Internet revenues will depend on the number of visitors who shop on our Internet site and the volume of orders we can fill on a timely basis. Problems with our Internet site or order fulfillment performance would reduce the volume of goods sold and could damage our reputation. We may experience system interruptions from time to time. If there is a substantial increase in the volume of traffic on our Internet site or the number of orders placed by customers, we may be required to expand and further upgrade our technology, transaction-processing systems and network infrastructure. We cannot assure you that we will be able to accurately project the rate or timing of increases, if any, in the use of our Internet site, or that we will be able to successfully and seamlessly expand and upgrade our systems and infrastructure to accommodate such increases on a timely and cost-effective basis.

The success of our Internet site depends on the secure transmission of confidential information over network and the Internet and on the secure storage of data. We rely on encryption and authentication technology licensed from third parties to provide the security and authentication necessary to effect secure transmission and storage of confidential information, such as customer credit card information. In addition, we maintain an extensive confidential database of customer profiles and transaction information. We cannot assure you 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 security we use to protect customer transaction and personal data contained in our customer database. In addition, other companies in the retail sector have from time to time experienced breaches as a result of actions by their employees. If any compromise of our security were to occur, it could have a material adverse effect on our reputation, business, operating results and financial condition, and could result in a loss of customers. A party who is able to circumvent our security measures could damage our reputation, cause interruptions in our operations and/or misappropriate proprietary information which, in turn, could cause us to incur liability for any resulting losses or damages. We may be required to expend significant capital and other resources to protect against security breaches or to alleviate problems caused by breaches.

We lease almost all of our store locations. If we are unable to maintain those leases or locate alternative sites for our stores on terms that are acceptable us, our net revenues and profitability could be adversely affected.

We lease 64 of our 65 current stores. We did not close any stores during fiscal 2006. In fiscal 2005, we closed two stores when the leases for those locations expired. In both instances, we opened a new store in similar locations during fiscal 2005. We cannot assure you that we will be able to maintain our existing store locations as leases expire, extend the leases or be able to locate alternative sites in our target markets and on favorable terms. If we cannot maintain our existing store locations, extend the leases or locate alternative sites on favorable or acceptable terms, our net revenues, profitability and financial condition could be adversely affected.

Our operating costs and profitability could be adversely affected if we are unable to accurately predict and respond to seasonal fluctuations in our business.

Our business is seasonal. The golf season and the number of rounds played in the markets we serve fluctuate based on a number of factors, including the weather. Accordingly, our sales leading up to and during the warm-weather golf season, as well as the December holiday gift-giving season, have historically contributed to a higher percentage of our annual net revenues and annual net operating income than other periods in our fiscal year. The months encompassing these seasons are responsible for the majority 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 expenditures leading up to and during these periods in anticipation of higher sales, including

acquiring additional inventory, preparing and mailing our catalogs, advertising, creating in-store promotions and hiring additional employees. In the event of unseasonable weather during the peak season in certain markets, our sales may be lower and we may not be able to adjust our inventory or expenses in a timely fashion. This seasonality may result in volatility or have an adverse effect on our results of operations or our financial condition.

Many of our stores are clustered in particular metropolitan areas, and an economic downturn or other adverse events in these areas may significantly reduce the sales for stores located in such areas.

A significant portion of our stores are clustered in certain geographic areas, including nine in the Tri-State (New York, New Jersey and Connecticut) area, seven in the San Francisco Bay area, six in the Los Angeles area, five each in the Chicago and Dallas areas, four in the Houston area and three in each of the Atlanta, Denver, Detroit and Phoenix areas. If any of these areas were to experience a downturn in economic conditions, natural disasters such as hurricanes, floods or earthquakes, terrorist attacks, or other negative events, the stores in these areas may be adversely affected.

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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:

guest demand in different geographic regions;

unseasonable weather during certain periods for certain geographic regions;

changes in our product mix;

our decision to relocate or refurbish certain stores;

the launch of promotional events;

the opening of new stores by us and our competitors in our existing markets; and

changes in economic conditions in the areas in which our stores are located.

Our comparable store sales have fluctuated significantly in the past, and such fluctuation may continue in the future. The percentage increase or decrease in comparable store sales compared to the prior fiscal year was 0.7% in 2004, 2.6% in 2005, and 2.0% in 2006. We have experienced decreases in comparable store sales during certain quarterly periods during the last two fiscal years and we cannot assure you that our comparable store sales will not decrease again in the future.

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 sales and profitability may be adversely affected.

Our results of operations depend in part on the success of our direct-to-consumer channel, which consists of our Internet site and multiple catalogs. Within our direct-to-consumer distribution channel, we believe that the success of our catalog operations also contributes to the success of our Internet site, because many of our guests who receive catalogs choose to purchase products through our Internet site. We believe that the success of our catalogs depends on our ability to:

achieve adequate response rates to our mailings;

offer an attractive merchandise mix;

cost-effectively add new guests;

cost-effectively design and produce appealing catalogs; and

timely deliver products ordered through our catalogs to our guests.

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 could materially and adversely affect our sales, profitability and financial condition.

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

We depend on the continued service of our executive officers, who possess significant expertise and knowledge of our business and industry. Currently, we do not maintain key person insurance for any of our officers or managers. Any loss or interruption of the services of a group or several of our executive officers could significantly reduce our ability to effectively manage our operations and implement our growth strategy, and we cannot assure you that we would be able to timely find appropriate replacements should the need arise.

Atlantic Equity Partners III, L.P. has significant influence over us, including the ability to nominate a majority of our board of directors, and its interests may conflict with the interests of our other stockholders.

The largest beneficial owner of our shares, Atlantic Equity Partners III, L.P. (Atlantic Equity Partners), an investment fund managed by First Atlantic Capital, Ltd. (First Atlantic Capital), beneficially owns 60.0% of our outstanding common stock. This includes 9.7% of our outstanding stock owned by Carl and Franklin Paul over which First Atlantic Capital has voting rights pursuant to a voting rights and stockholders agreement among Atlantic Equity Partners and Carl and Franklin Paul. Under the agreement, Carl and Franklin Paul have also agreed that they will only transfer the shares subject to the agreement on a pro rata basis when Atlantic Equity Partners transfers its shares. As a result of its own stockholdings and this agreement, Atlantic Equity Partners, and indirectly First Atlantic Capital, will have the ability to control all matters submitted to our stockholders for approval, including:

- the composition of our board of directors, which has the authority to direct our business and appoint and remove our officers;

- approving or rejecting a merger, consolidation or other business combination; and

- amending our certificate of incorporation and bylaws which govern the rights attached to our common stock.

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In addition, we and Atlantic Equity Partners have entered into a management rights agreement. Pursuant to this agreement, following a reduction of the equity owned by Atlantic Equity Partners to below 50% of our outstanding equity, it will retain the right to cause the board of directors to nominate a specified number of designees for the board of directors, and continue to be able to significantly influence our decisions.

This concentration of ownership of our common stock could delay lead to or affect the results of possible proxy contests, mergers, acquisitions, tender offers, purchases or sales of assets, open-market purchase programs or other public or private transactions involving our common stock or other securities.

Our sales, profitability and company-wide operations would be adversely affected if the operations of our Austin, Texas call center or distribution and fulfillment center were interrupted or shut down.

We operate a centralized call center and distribution and fulfillment center in Austin, Texas. We handle almost all our Internet site and catalog orders through our Austin facility. We also receive and ship a significant portion of our retail stores inventory through our Austin facility. Any natural disaster or other serious disruption to this facility would substantially disrupt our operations and could damage all or a portion of our inventory at this facility, impairing our ability to adequately stock our stores and fulfill guest orders. 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 sales, profitability, financial condition and operations throughout our company.

A disruption in the service or a significant increase in the cost of our primary delivery service for our direct-to-consumer operations would have a material adverse effect on our sales and profitability.

We use United Parcel Service, or UPS, for substantially all of our ground shipments of products sold through our Internet site and catalogs to our guests in the United States. Any significant disruption to UPS's services would impede our ability to deliver our products through our direct-to-consumer channel, which could cause us to lose sales or guests. In addition, if UPS were to significantly increase its shipping charges, we may not be able to pass these additional shipping costs on to our guests and still maintain the same level of direct-to-consumer sales. In the event of disruption to UPS's services or a significant increase in its shipping charges, we may not be able to engage alternative carriers to deliver our products in a timely manner on favorable terms, which could have a material adverse effect on our sales, profitability and financial condition.

An increase in the costs of mailing, paper, and printing our catalogs would adversely affect our profitability.

Unlike many of our competitors, we generate a significant percentage of our revenues through our direct-to-consumer channel, including catalog orders. 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 profitability.

If we are unable to enforce our intellectual property rights, our net revenues and profitability may decline.

Our success and ability to compete are dependent, in part, on sales of our proprietary-branded merchandise. We currently hold a substantial number of registrations for trademarks and service marks to protect our own proprietary brands. We also rely to a lesser extent on trade secret, patent and copyright protection, employee confidentiality agreements and license agreements to protect our intellectual property rights. We believe that the exclusive right to use trademarks and service marks has helped establish our market share. If we are unable to continue to protect the trademarks and service marks for our proprietary brands, if such marks become generic or if third parties adopt marks similar to our marks, our ability to differentiate our products and services may be diminished. In the event that our trademarks or service marks are successfully challenged by third parties, we could lose brand recognition and be forced to devote additional resources to advertising and marketing new brands for our products.

From time to time, we may be compelled to protect our intellectual property, which may involve litigation. Such litigation may be time-consuming, expensive and distract our management from running the day-to-day operations of our business, and could result in the impairment or loss of the involved intellectual property. There is no guarantee that the steps we take to protect our intellectual property, including litigation when necessary, will be successful. The loss or reduction of any of our significant intellectual property rights could diminish our ability to distinguish our

products from competitors products and retain our market share for our proprietary products. Our proprietary products sold under our proprietary brands generate higher margins than products sold under third party manufacturer brands. If we are unable to effectively protect our proprietary intellectual property rights and fewer of our sales come from our proprietary products, our net revenues and profits may decline.

We may become subject to intellectual property suits that could cause us to incur substantial costs or pay substantial damages or prohibit us from selling our products.

Third parties may from time to time 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 may divert the attention of our management and key personnel from our business operations. Claims for alleged

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infringement and any resulting lawsuit, if successful, could subject us to significant liability for damages, increase the costs of selling some of our products and damage our reputation. Any potential intellectual property litigation could also force us to stop selling certain products, obtain a license from the owner to use the relevant intellectual property, which license may not be available on reasonable terms, if at all, or redesign our products to avoid using the relevant intellectual property.

We may be subject to product warranty claims or product recalls which could harm our reputation, adversely affect our sales and cause us to incur substantial costs or pay substantial damages.

We may be subject to risks associated with our proprietary-branded products, including product liability. Our existing or future proprietary 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 and, in turn, sales of our products. In May 2002, we learned that some of our proprietary products sold in the prior two years were not manufactured in accordance with their design specifications. Upon discovery of this discrepancy, we offered our customers refunds, replacements or gift certificates. As a result, in fiscal 2002 we recognized \$300,000 in product return and replacement expenses. We cannot assure you that problems like this will not happen again in the future, or if they do, that the costs and other adverse consequences will not be more severe. In addition, it is possible that we could face similar risks with respect to the premier-branded products we sell.

Disruption of operations of ports through which our products are imported from Asia could have a material adverse effect on our sales and profitability.

We import substantially all of our proprietary products from Asia under short-term purchase orders, and a significant amount of the premier-branded products we sell is also manufactured in Asia. If a disruption occurs in the operations of ports from which our products are exported or through which our products are imported, we and our vendors may have to ship some or all of our products from Asia by air freight. Shipping by air is significantly more expensive than shipping by boat, and if we cannot pass these increased shipping costs on to our guests, 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 and financial condition.

We may pursue strategic acquisitions, which could have an adverse impact on our sales and operating results, and could divert the attention of our management.

Although we currently do not have any agreement or understanding to make any acquisitions, from time to time, we may grow our business by acquiring complementary businesses, products or technologies. Acquisitions that we may make in the future entail a number of risks that could materially and adversely affect our business and operating results. Negotiating potential acquisitions or integrating newly acquired businesses, products or technologies into our business could divert our management's attention from other business concerns and could be expensive and time-consuming. Acquisitions could expose our business to unforeseen liabilities or risks associated with entering new markets or businesses. In addition, we might lose key employees while integrating new organizations. Consequently, we might not be successful in integrating any acquired businesses, products or technologies, and might not achieve anticipated sales and cost benefits. In addition, future acquisitions could result in customer dissatisfaction, performance problems with an acquired company, or issuances of equity securities that cause dilution to our existing stockholders. Furthermore, we may incur contingent liabilities or possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances, any of which could harm our financial condition.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

At December 30, 2006, we operated 62 stores in 14 states. With the exception of the Austin store at